SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1917.

No. 421.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA, PETITIONER.

vs.

HENRY TURRISH.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

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Pleas and proceedings in the United States Circuit Court of Appeals for the Eighth Circuit, at the September term, 1916, of said court, before the Honorable Walter H. Sanborn, the Honorable Elmer B. Adams, and the Honorable John E. Carland, Circuit Judges.

Attest:

JOHN D. JORDAN,
Clerk of the United States Circuit Court of Appeals for the Eighth Circuit.
[SEAL.]
By E. E. KOCH,
Asst. Clerk.

Be it remembered that heretofore, to wit: On the twelfth day of February, A. D. 1916, a transcript of record pursuant to a writ of error directed to the District Court of the United States for the District of Minnesota, was filed in the office of the clerk of the United States Circuit Court of Appeals for the Eighth Circuit in a certain cause wherein E. J. Lynch, Collector of Internal Revenue for the district of Minnesota, was Plaintiff in Error, and Henry Turrish was Defendant in Error, which said transcript as prepared and printed under the rules of the United States Circuit Court of Appeals for the Eighth Circuit, under the supervision of its clerk, is in the words and figures following, to wit:

1 United States District Court, District of Minnesota, Third Division.

HENRY TURRISH, PLAINTIFF,
vs.
E. J. LYNCH, AS UNITED STATES COLLECTOR OF INTERNAL revenue for the Collection District of Minnesota, Defendant.

Pleas before the Honorable the Judges of the United States District Court for the district of Minnesota.

Be it remembered, that on the 27th day of October, A. D. 1915, the plaintiff in the above entitled cause filed in the office of the clerk of said court a complaint, which said complaint is in the words and figures following, to-wit:

Complaint.

United States of America. In the District Court, District of Minnesota, Third Division.

HENRY TURRISH, PLAINTIFF,
vs.
E. J. LYNCH, AS UNITED STATES COLLECTOR OF INTERNAL revenue for the Collection District of Minnesota, Defendant.

The above-named plaintiff, for his complaint herein, complains of the above-named defendant and alleges as follows:

I.

This plaintiff is a citizen of the United States, and a resident of the city of Duluth, in the State and collection district of Minnesota, and is and was during the entire year 1914, a married man, living with his wife.

II.

The defendant herein is a resident of the city of St. Paul, in the State and District of Minnesota, and the third division thereof, and is the duly appointed and qualified collector of internal revenue of the United States of America for the collection district of Minnesota.

III.

Prior to March 1st, 1915, this plaintiff made, verified, and filed with the defendant herein as collector as aforesaid, in manner and form required by law, and the regulations of the Secretary of the Treasury, a return of his income for the calendar year 1914, in accordance with the requirements of paragraph D of section 2 of the act of Congress approved October 3, 1913, entitled "An act to reduce tariff duties and provide revenue for the Government, and for
2 other purposes," the said section of said act being commonly known, and always hereinafter referred to as the "Income-tax law." Said return stated and showed that in the year 1914, this plaintiff received a gross income amounting to the sum of $39,670.47, composed of the following items:

Total amount derived from—	
Business, trade, commerce, sales or dealings in property, whether real or personal	$4,300.00
Interest on bonds, mortgages or deeds of trust, or other similar obligations of domestic corporations, joint stock companies, or associations and insurance companies	31,696.47
Royalties from mines, oil wells, patents, franchises, or other legalized privileges	600.00
Other sources not enumerated above	3,074.00
Total	39,670.47

Of the above items of gross income, the said return stated and showed that the normal tax provided for by the said income-tax law had been paid at the source on the item of $3,074.00.

Said return stated and showed that this plaintiff had and claimed deductions from gross income, allowable under the provisions of paragraph B of said income-tax law, as follows:

The amount of necessary expenses actually paid within the calendar year for which a return is made, in carrying on business	$6,356.62
All interest paid within the year on personal indebtedness	121,156.94
All annual State, county, school, and municipal taxes paid within the year	996.08
Losses actually sustained during the year incurred in trade, or arising from fires, storms, or shipwreck, and not compensated by insurance or otherwise	999.75
Total	129,509.39

Said return further stated and showed that this plaintiff had and claimed as a specific deduction and exemption allowed in the computing of the normal tax provided for by said income tax law, the amount of the above income upon which the normal tax had been paid at the source, to wit, the sum of $3,074.00.

Said return further stated and showed that this plaintiff had and claimed as a specific exemption allowed by paragraph C of said income-tax law, the sum of $4,000.00.

Said return was a true and correct return of all of the plain-
3 tiff's gross income, required to be returned or legally taxable under the said income-tax law, unless the item of $122,551.00 consisting of distributions from corporations and more particularly hereinafter described, or some part thereof, should have been included in plaintiff's gross income. All statements of and claims for general deductions and specific deductions and exemptions made and stated in said return, were true and correct, and were deductions and exemptions which the plaintiff was and is entitled to under the provisions of paragraphs B and C of said income-tax law, and said deductions and exemptions have never been questioned by the defendant or the Commissioner of Internal Revenue, but have been at all times recognized and accepted as correct, both in character and amount. Said return so made showed that this plaintiff had no net income whatsoever, for the year ending December 31, 1914, and no assessment was in fact made against this plaintiff by the Commissioner of Internal Revenue, or otherwise, upon said return.

IV.

On or about the 5th day of October, 1915, the Commissioner of Internal Revenue of the United States, having received information that this plaintiff had received in the year 1914, from domestic corporations subject to the normal tax provided for in the said income tax law, distributions amounting in the aggregate to $122,551.00, and assuming and pretending to act under and by virtue of authority conferred upon him by said income tax law, assessed against this plaintiff an income tax for the year 1914 amounting to $127.12, and this

plaintiff is informed and believes, and therefore alleges, that the said assessment was computed and made by said Commissioner of Internal Revenue upon the following basis, and no other:

The said Commissioner of Internal Revenue determined and held that the distributions from corporations hereinabove referred to, received by this plaintiff in the year 1914, constituted income derived from dividends of domestic corporations subject to tax under said income tax law, within the meaning of the said law, and added the amount of said distributions, to wit: $122,551.00, to the items of gross income described hereinabove, and set out by this plaintiff in his return hereinabove more specifically described, and that by said process the said commissioner determined and found that this plaintiff had a gross income in the year 1914, amounting to the sum of $162,221.47. The commissioner further found that this plaintiff was entitled, under the provisions of paragraph B of said income tax law, to the items of general deduction hereinabove specifically described, and stated and claimed by this plaintiff in his said return, amount-
4 ing in the whole to $129,509.39. The said commissioner also found and determined that this plaintiff was entitled to specific deductions and exemptions, allowed by paragraphs B and C of said income tax law, in computing the normal tax provided for in and by said law, the following items: income on which the normal tax had been paid at the source, $3,074.00; specific exemption allowed by paragraph C of said income tax law, $4,000.00 (the said two items being the same items of specific deductions and exemptions claimed and stated by this plaintiff in his said return as hereinabove alleged); and also the sum of $122,551.00, to wit, the amount of distributions received by this plaintiff from corporations in the year 1914, which was treated by said commissioner as above alleged as income derived from dividends on the stock of domestic corporations subject to the income tax law, and therefore a part of this plaintiff's gross income, and which amount, if treated as dividends, was [deductable] for the purpose of computing the normal tax under the provisions of paragraph B of said income tax law, and was actually so deducted by the said commissioner. As computed by said Commissioner of Internal Revenue, this plaintiff was found by said commissioner to have received in the year 1914 a net income of $32,712.08; in as much as the specific deductions and exemptions found and allowed by the said commissioner under the provisions of paragraphs B and C of said income tax law for the purpose of computing the normal tax exceeded the net income of this plaintiff, no normal tax was assessed against this plaintiff by the said commissioner; but as the net income of this plaintiff as so computed by said commissioner, exceeded the sum of $20,000.00, said commissioner decided and found that this plaintiff was liable for an additional or supertax at the rate of 1 per cent upon the amount by which said net income so computed exceeded the sum of $20,000.00, to wit, the sum of $12,712.08; and upon this basis and theory, and upon such a computation of the income of this plaintiff for the year 1914, and not otherwise, the said Com-

missioner of Internal Revenue assessed against this plaintiff the tax of $127.12 hereinabove described.

V.

On or about the 9th day of October, 1915, the defendant herein, as collector as aforesaid, served upon this plaintiff a written notice and demand, notifying this plaintiff that there had been assessed against him the tax of $127.12 hereinabove described, and demanding of this plaintiff the payment of said tax, and in and by said notice and demand the defendant herein threatened, if the said tax was not paid, to enforce the collection thereof, with the penalties by said income tax law provided, and in manner and form as by law provided.

VI.

Thereupon, and in order to prevent the accrual of penalties and distraint of plaintiff's property, on or about the 9th day of October, 1915, the plaintiff paid to the said defendant, as United States collector as aforesaid, the said sum of $127.12, being the amount of the tax assessed as aforesaid, under duress and under written protest, which protest is in the words and figures following, to wit:

ST. PAUL, MINN., *October 9th, 1915.*

To the Secretary of the Treasury, the Commissioner of Internal Revenue, and E. J. Lynch, collector:

There has this day been served upon me a notice of assessment against me of an individual income tax of $127.12, for the tax year 1914, together with a demand for payment of said sum.

You will take notice that I pay said tax following such notice and demand, and under protest and duress, and not otherwise, and protest against the assessment and collection of said tax and all thereof, on the ground that the assessment thereof is not based upon net income received by me in the year 1914 or at any other time, which was or is taxable under the law.

And I request that there be noted upon the receipt for said taxes, and upon the proper records of your respective offices, the fact that I pay said tax under protest.

(Signed) HENRY TURRISH.

VII.

Thereafter, and on or about the 9th day of October, 1915, this plaintiff made and filed with the defendant herein, and the said Commissioner of Internal Revenue, an application and appeal for the refund of said sum of $127.12, so paid under protest and duress, in manner and form as provided in section 3226 of the Revised Statutes of the United States, the provisions of the law in that regard, and the regulations of the Secretary of the Treasury established in

pursuance to said law, and thereafter, and on the 13th day of October, 1915, the plaintiff's said application and appeal were rejected and denied in toto by the said Commissioner of Internal Revenue.

VIII.

Said tax of $127.12 hereinabove described, assessed, demanded, and paid as hereinbefore alleged, was wholly illegal and void, for the following reasons, and by virtue of the following facts, which this plaintiff hereby alleges to be true:

6 1. Of the sum of $122,551.00 received by this plaintiff in the year 1914, as distributions from corporations subject to the income-tax law, and which sum was, by the Commissioner of Internal Revenue and as hereinabove alleged, treated as and held to be income derived from dividends received by the plaintiff on the stock of domestic corporations, the sum of $79,975.00 was received by this plaintiff in the year 1914 as distributions from Payette Lumber & Manufacturing Company (always hereinafter referred to as the "Payette Company"), under the circumstances hereinafter alleged.

2. The said Payette Company is a corporation created, organized, and existing under and by virtue of the laws of the State of Minnesota, and at all times herein mentioned, admitted, and authorized to hold property and transact business in the State of Idaho.

3. The said Payette Company was organized for the purpose of, and had the power to buy, hold, own, and sell real property, and particularly timber lands in the State of Idaho; and the said company has in fact never engaged in any business other than the purchasing of timber lands in said State of Idaho, the care and management of lands so purchased, including the payment of taxes thereon, and the sale thereof as hereinafter alleged, except such minor business as was incidental to and connected with the buying, owning, holding, managing, and selling of said timber lands.

4. The authorized capital stock of said Payette Company was $1,500,000.00, divided into 15,000 shares of the par value of $100.00 each. That prior to the first day of March, 1913, all of said capital stock had been subscribed and paid for at par value in cash, and was outstanding. Prior to the date last hereinabove mentioned, and at all times thereafter, up to the time of the surrender of his stock as hereinafter alleged, this plaintiff was the owner of 799¾ shares of said stock of said Payette Company of the par value of $79,975.00, which sum this plaintiff had paid for said stock.

5. The said Payette Company was organized in the year 1903, and thereafter it immediately began to invest its capital, and prior to said 1st day of March, 1913, said Payette Company had invested in, acquired, and owned timbered lands in the State of Idaho of great value, at a cost to said company of approximately $1,375,000.00, and had invested the remainder of its capital in other assets, the ownership of which was incidental to and connected with its said business of owning and holding timber lands. During the entire time of its

existence, prior to March 1st, 1913, and to the sale hereinafter described, the said Payette Company had done no business, except as above stated. Prior to the date of the distribution hereinafter
7 described and alleged, said Payette Company had declared no dividends and made no distributions of any kind to its stockholders.

6. On March 1st, 1913, and on the date of the sale hereinafter described, the said Payette Company still owned all of the property so acquired by it as above alleged, and upon said March 1st, 1913, and all of the dates hereinafter mentioned, subsequent to that time, the fair and actual market value of the said assets of said company over and above the amount of its debts and liabilities was not less than $3,000,000.00, of which sum the value of the timber lands owned by said company, the owning and holding of which was the principal business of said company, was on said date not less than $2,875,000.00. The aforesaid increase in value of said assets and of said timber land over and above the first cost thereof was occasioned entirely by the gradual rise in market value of such timber land after the same was purchased by said Payette Company and not at all by any dealing therein or use thereof by said Payette Company or any business done by said company.

7. The fair and actual value of plaintiff's stock on March 1st, 1913, and at all times thereafter, until its surrender as hereinafter alleged, was $159,950.00, or twice its par value.

8. On or about March 21st, 1913, this plaintiff made, executed, and delivered to C. A. Weyerhaeuser and William Carson an option in writing to purchase the stock of this plaintiff in said Payette Company for the sum of $150,950.00, at any time prior to July 1st, 1913. On or about the same date all of the other stockholders of said Payette Company made similar options to the same parties for the purchase of their respective shares of stock, at twice their par value, at any time prior to July 1st, 1913. Prior to July 1st, 1913, and in the month of June in that year, all of the said stockholders in said Payette Company, including this plaintiff, by instrument in writing extended said option to December 31st, 1913. Sometime in the year 1913, subsequent to July 1st, and prior to December 27th of that year, said C. A. Weyerhaeuser and William Carson, with other associates, caused to be organized under the laws of the State of Idaho, Boise-Payette Lumber Company, for the purpose, among other things, of acquiring the property and franchises of the Payette Company. The said Boise-Payette Lumber Company informed the Payette Company and its stockholders, prior to December 27, 1913, that instead of exercising the option hereinabove described it preferred and proposed to purchase all of the assets of the Payette Company, paying to said Payette Company such a purchase price therefor that there would be available for distribution to the stockholders of the Payette Company, and they would realize upon
8 their stock twice the par value thereof. Thereupon, and on December 27, 1913, the stockholders of the Payette Company,

by resolution duly passed and adopted, authorized the sale of all of [all of] the property, assets, and franchises of said company to Boise-Payette Lumber Company for $3,000,000.00 in cash, and the agreement by said company to pay all of the debts and liabilities of the Payette Company and carry out and perform all of its contracts. And on December 29, 1913, the board of directors of said Payette Company, by resolution duly passed, offered to sell to Boise-Payette Lumber Company all of the property, assets, and franchises of the Payette Company for the consideration above named.

9. Thereafter Boise-Payette Lumber Company accepted said offer, and on or about the 9th day of March, 1914, the said Boise-Payette Lumber Company paid to the said Payette Company the sum of $3,000,000.00 in cash and in writing assumed and agreed to pay all of the outstanding debts and liabilities of said Payette Company and to carry out and perform all of its unfulfilled contracts, and thereupon said Payette Company conveyed, transferred, and assigned to said Boise-Payette Lumber Company all of the assets and property, real, personal, and mixed, and franchises belonging to said Payette Company. Upon the completion of said transaction the said Payette Company had no assets or property of any kind, except the $3,000,000.00 in cash which had been so paid to it by the Boise-Payette Lumber Company and no debts, liabilities, or obligations except those which said Boise-Payette Lumber Company had assumed and agreed to pay and perform.

10. Upon the completion of said transaction and transfer the board of directors of said Payette Company, by resolution duly passed in due and proper form, and on the said 9th day of March, 1914, authorized and directed the payment of said $3,000,000.00 in cash then belonging to said Payette Company to its stockholders, pro rata. It was a condition of said payment and distribution that said stockholders surrender the certificates of stock of said company held by it. That immediately thereafter, and in the month of March, 1914, said Payette Company distributed to its stockholders, pro rata, the said entire sum of $3,000,000.00, and all of the stockholders surrendered their certificates for shares of stock therein.

11. In and by said distribution so made there was distributed and paid to this plaintiff as the owner of 799½ shares of the capital stock of said Payette Company the sum of $159,950.00, which was exactly two times the par value of his said shares of stock, and this plaintiff surrendered all of the stock certificates of said Payette Company held by him.

12. After the distribution of said sum of $3,000,000.00 by said Payette Company to its stockholders, as hereinabove al-
9 leged, said company had no assets, and has engaged in no business, although it has not been, as this plaintiff is informed and believes, formally and legally dissolved in accordance with the statutes in that case made and provided.

13. Of the said sum of $159,950.00 so distributed to this plaintiff by the said Payette Company as hereinabove alleged, the Commis-

sioner of Internal Revenue, as hereinabove alleged, treated one-half thereof, or the sum of $79,975.00 as a dividend paid to this plaintiff by said Payette Company in the year 1914, and held that the said last mentioned amount was income derived by this plaintiff in the year 1914, from dividends received from a domestic corporation subject to the income tax law. Unless said sum of $79,975.00 had been determined to be and treated by said Commissioner of Internal Revenue as a part of the gross income of this plaintiff for the purpose of ascertaining his net income liable to tax under the income tax law hereinabove described, then this plaintiff would and could have had no net income in the year 1914, and no income tax could or would have been assessed against him on account of his income for said year under the provisions of said law or otherwise.

And in that behalf this plaintiff alleges that the distribution to and receipt by him of $79,975.00 constituted and was a return to him of capital assets owned by him at the date of the taking effect of said income tax law, to wit, March 1st, 1913, and that within the true intent and meaning of said income tax law, such distribution was not income which was taxable in itself, nor was it income which could be taken into account in computing or determining the net taxable income of an individual.

15. And this plaintiff further alleges that even if within the true intent and meaning of said income tax law the said item of $79,975.00 constituted a portion of the gross income of this plaintiff for the year 1914, nevertheless and in that event he was entitled to and there should have been allowed him as a deduction, either as a loss actually sustained during the year, or as a reasonable allowance for the exhaustion of property, under the provisions and within the meaning and intent of paragraph B of said income tax law, the amount by which the actual value on March 1st, 1913 of the capital stock of this plaintiff in said Payette Company over and above the par value thereof, was reduced, depreciated, and destroyed by the distribution made to this plaintiff as hereinabove alleged, to wit, the sum of $79,975.00. And this plaintiff further alleges that if said deduction had been allowed to this plaintiff by the Commissioner of Internal Revenue in computing the net income of this plaintiff for the year 1914, this plaintiff would have had no net income for said year, and no income tax to any amount could legally have been assessed against him.

16. And this plaintiff further alleges that if, within the true meaning and intent of said income tax law, the said sum of $79,975.00 constituted income which was to be considered in computing the net taxable income of an individual thereunder, and if within the true intent and meaning of said law no deduction is allowed this plaintiff, for loss of or reasonable allowance for exhaustion of his property as hereinabove alleged, then said income tax law was and is, to that extent, unconstitutional and void, and in contravention of the provisions of the Constitution of the United States, and particularly the following portions thereof:

Article I, section 2, clause 3; article I, section 9, clause 4; and the 16th amendment to the Constitution, for the reason that said law attemps to tax that which is not income, within the meaning of said 16th amendment, but is property, and the tax imposed by said law is a direct tax not apportioned among the several States according to their respective numbers.

IX.

That by reason of the facts hereinbefore stated and alleged, there is due and owing to this plaintiff from the defendant herein, the amount of the tax hereinabove described assessed, demanded, and paid as hereinabove alleged, to wit, $127.12, with interest thereon from the 9th day of ctober, 1915.

Wherefore, plaintiff demands judgment against the defendant herein for the sum of $127.12, with interest thereon from October 9th, 1915, and for his costs and disbursements herein incurred.

CLAPP & MACARTNEY,
H. C. OLDENBURG,
HAROLD J. RICHARDSON,
Attorneys for Plaintiff.

STATE OF MINNESOTA, }
County of St. Louis. } ss.

Henry Turrish, being by me first duly sworn, deposes and says that he is plaintiff in the above-entitled action; that he has read the foregoing complaint and knows the contents thereof, and that the same is true of his own knowledge, except as to those matters which are therein stated upon information and belief, and as to those matters that he believes it to be true.

HENRY TURRISH,

Subscribed and sworn to before me this 25th day of October, A. D. 1915.

SEVER LOHN,
[SEAL.] *Notary Public, St. Louis County, Minn.*
My commission expires May 25, 1921.
(Endorsed:) Filed in the District Court on Oct. 27, 1915.

11 *Summons and marshal's return—Return on service of writ.*

UNITED STATES OF AMERICA, }
District of Minnesota, } ss:

I hereby certify and return that I served the annexed summons on the therein-named E. J. Lynch, as United States collector of internal revenue, by handing to and leaving a true and correct copy thereof with him personally at St. Paul, in said district, on the 27th day of October, A. D. 1915.

WM. H. GRIMSHAW, *U. S. Marshal.*
By S. J. PICHA, *Deputy.*

Summons.

UNITED STATES OF AMERICA,
District of Minnesota, } ss:

In the District Court of the United States for the District of Minnesota, Third Division.

HENRY TURRISH, PLAINTIFF,
against
E. J. LYNCH, AS UNITED STATES COLLECTOR OF INTERNAL REVENUE for the collection district of Minnesota, defendant. } Summons.

The President of the United States of America to the defendant above named, greeting:

You are hereby summoned and required to answer the complaint in this action, which has been filed in the office of the clerk of this court, in the city of St. Paul, in said district of Minnesota, third division, and file your answer in said clerk's office within twenty days after the service hereof, excluding the day of such service, and if you fail to answer the complaint as aforesaid, the plaintiff will take judgment against you for the sum of one hundred and twenty-seven and 12/100 dollars ($127.12), with interest thereon from October 9th, 1915, together with the costs and disbursements of this action.

For the marshal of the United States for the District of Minnesota to execute.

Witness, the honorable Page Morris, judge of the District Court of the United States of America for the District of Mimesota at St. Paul, in said district, this 27th day of October, in the year of our Lord one thousand nine hundred and fifteen, and of our independence the one hundred and fortieth year.

CHARLES L. SPENCER, *Clerk.*
By MARGARET L. MULLANE, *Deputy.*

CLAPP & MACARTNEY,
Plaintiff Attorney, St. Paul, Minn.

(Endorsed:) Summons. Filed October 28th, 1915. Charles L. Spencer, Clerk, by Margaret L. Mullane, Deputy.

12 *Stipulation amending complaint.*

It is hereby stipulated by and between the above-named parties by their respective attorneys that the complaint in the above entitled action may be amended by striking out subdivision No. 3 of paragraph VIII of said complaint and inserting in lieu thereof the following:

"3. The said Payette Company was organized for the purpose of and had the power to carry on and conduct a general logging, lum-

bering, and manufacturing business, and had the power to buy, own, improve, sell, and hold real property, including timber and timber lands, and other powers. That the timber lands hereinafter referred to were purchased and held with the purpose of logging and manufacturing the same into lumber, but that said company in fact never engaged in any business other than the purchasing of timber lands in said State of Idaho, and the care and management of lands so purchased, including the payment of taxes thereon, and the sale thereof as hereinafter alleged, except such minor business as was incidental to and connected with the buying, owning, holding, and managing of said timber lands."

Dated at St. Paul, December 18th, 1915.

CLAPP & MACARTNEY,
H. OLDENBURG,
H. J. RICHARDSON,
Attorneys for Plaintiff.

ALFRED JAQUES,
United States District Attorney,
Attorney for Defendant.

(Endorsed:) Filed in the District Court on Dec. 18, 1915.

Demurrer to complaint.

Now comes the defendant, and demurs to the complaint in the above entitled action, on the ground that the same does not state facts sufficient to constitute a cause of action.

ALFRED JAQUES,
United States Attorney, District of Minnesota,
for the Defendant.

(Endorsed:) Filed in the District Court on Dec. 20, 1915.

Record entry of hearing of demurrer to complaint.

December term, 1915. December 20, 1915. Before Judge Booth.

By agreement of the attorneys for the parties to the above-entitled cause said cause is brought on this day to be heard upon the
13 demurrer of said defendant to the complaint herein, Messrs. Clapp & Macartney appearing as attorneys for said plaintiff, and Alfred Jaques, Esq., appearing as attorney for said defendant.

Argument upon said demurrer is heard in part and is continued for further hearing until the following day.

Record entry of hearing of demurrer to complaint.

December 21, 1915; demurrer overruled.

Pursuant to continuance, further argument on the demurrer in the above-entitled cause is this day had, the parties to the said cause

appearing by their same attorneys, respectively, as on the preceding day. And the said arguments having been concluded, and said demurrer submitted to and duly and maturely considered by the court, it is by the court

Ordered, that the demurrer of the defendant to the complaint herein be and the same hereby is overruled.

An exception to this order is allowed to defendant.

Judgment.

United States District Court, District of Minnesota, Third Division.

Term minutes, December term, A. D. 1915. January 31st, 1916, Monday morning.

Court opened pursuant to adjournment.

Present: Honorable Wilbur F. Booth, judge.

HENRY TURRISH, PLAINTIFF, vs. E. J. LYNCH, AS UNITED STATES COLLECTOR OF INTERNAL revenue for the collection district of Minnesota, defendant.	No. 873.

It appearing to the court that the above-named defendant, E. J. Lynch, United States collector of internal revenue for the collection district of Minnesota, has been duly served with process, and that on the 21st day of December, A. D. 1915, a demurrer of said defendant to the complaint herein was overruled by this court, and that more than twenty days have elapsed since the day said demurrer was so overruled, and that said defendant has failed to answer or further plead to said complaint. Now, on motion of Messrs. Clapp and Macartney, attorneys for said plaintiff, a default is hereby entered against said defendant, and it is by the [Cou]

Considered, ordered, and adjudged that the above-named plaintiff, Henry Turrish, do have and recover of and from said defendant, E. J. Lynch, United States collector of internal revenue for the collection district of Minnesota, the sum of one hundred twenty-seven and 12/100 dollars ($127.12), with interest thereon from the 9th day of October, A. D. 1915, at the rate of 6% per annum, amount-
14 ing to $2.37, as demanded in said complaint, and being in all the sum of one hundred twenty-nine and 49/100 dollars ($129.49), together with the costs and disbursements of said plaintiff in this behalf expended, and taxed at the sum of $17.41; and that said plaintiff do have execution therefor.

Bill of exceptions.

Filed February 5, 1916.
December 21st, 1915.
Present: Honorable Wilbur F. Booth, judge.

The above-entitled cause of action came on before the court at the city of St. Paul, in said State, district, and division, on the 20th and 21st days of December, 1915, for argument on the demurrer to the complaint interposed by the defendant, on the ground that the complaint fails to state facts sufficient to constitute a cause of action.

Messrs. Clapp & McCartney, H. Oldenburg, and H. J. Richardson appearing as attorneys for plaintiff, and Alfred Jaques, United States attorney, appearing as attorney for defendant.

And the court having listened to the arguments of the respective counsel and being fully advised in the premises, after due consideration had, did enter an order and decision in all things overruling the demurrer of the defendant.

Whereupon the defendant duly excepted to the above order, decision, or ruling of the court overruling the demurrer of the defendant to the complaint of the plaintiff, which exception was duly allowed by the court, and more than twenty days having elapsed after the day said demurrer was overruled, and the said defendant having failed and declined to answer or further plead to said complaint on the 31st day of January, 1916, judgment was entered in said action as follows:

"It is by the court considered, ordered, and adjudged that the above-named plaintiff, Henry Turrish, do have and recover of and from said defendant E. J. Lynch, United States collector of internal revenue for the collection district of Minnesota, the sum of one hundred twenty-seven and 12/100 dollars ($127.12), with interest thereon from the 9th day of October, A. D. 1913, at the rate of 6% per annum, amounting to $2.37, as demanded in said complaint, and being in all the sum of one hundred twenty-nine and 49/100 dollars ($129.49), together with the costs and disbursements of said plaintiff in this behalf expended, and taxed at the sum of $17.41; and that said plaintiff to have execution therefor."

15 *Certificate to bill of exceptions.*

The foregoing document having been examined and having been found to contain a full, correct, and complete statement of the proceedings had at the trial of the action above entitled,

It is hereby allowed and signed as the bill of exceptions of the defendant in said action.

Dated this 3rd day of February, 1916.

WILBUR F. BOOTH, *Judge.*

It is hereby stipulated, by and between the parties to the above entitled action, that the above bill of exceptions proposed by the de-

fendant may be allowed and signed by the judge of said court as and for the bill of exceptions in said action, and may be filed as the bill of exceptions of the defendant in said action.

Dated February 2nd, 1916.

CLAPP & MACARTNEY,
H. J. RICHARDSON,
H. OLDENBURG,
Attorneys for Plaintiff.
ALFRED JAQUES,
United States Attorney for the Defendant.

(Endorsed:) Filed in the District Court on February 5, 1916.

Assignment of errors.

Now comes the defendant in the above-entitled cause and files the following assignment of error upon which it will rely in its prosecution of the appeal in the above-entitled cause bringing up for review the judgment made and entered in said court on the 31st day of January, 1916:

I.

That the United States District Court for the District of Minnesota, Third Division, erred in overruling the demurrer interposed by the defendant to the complaint of the plaintiff in the cause.

Wherefore, defendant asks that said judgment be reversed, and that said District Court for the District of Minnesota, Third Division, be ordered and directed to enter judgment in favor of the defendant, or to grant a new trial of said cause.

ALFRED JAQUES,
United States Attorney for Defendant.

(Endorsed:) Filed in the District Court on Feb. 5, 1916.

16 *Petition for and order allowing writ of error.*

To the Honorable District Court of the United States, District of Minnesota, Third Division.

The defendant in the above-entitled action, feeling himself aggrieved by the judgment rendered and entered in the above-entitled action on the 31st day of January, 1916, comes now by his attorney and petitions your honorable court for an order allowing said defendant to prosecute a writ of error to the United States Circuit Court of Appeals for the Eighth Circuit of the United States, according to the laws of the United States in that behalf made and provided, and also your petitioner prays that the transcript of all the proceedings in said cause, together with the assignments of error

filed herein, be duly authenticated and with the same be sent to the Circuit Court of Appeals.

ALFRED JAQUES,
United States Attorney for the Defendant.

Order allowing writ of error.

Upon motion of Alfred Jaques, United States attorney and attorney for the defendant in the above-entitled cause, and upon the filing of the foregoing petition for a writ of error, and upon the filing of the assignments of error herein,

It is by the court hereby ordered, that the writ of error be, and the same is hereby, allowed, to have reviewed in the United States Circuit Court of Appeals for the Eighth Circuit, the said judgment entered herein on the 31st day of January, 1916.

It is further ordered that all further proceedings in this court be suspended and stayed until the determination of said writ of error.

Dated this 5th day of February, 1916.

WILBUR F. BOOTH,
District Judge.

(Endorsed:) Filed in the District Court on Feb. 5, 1916.

Præcipe for transcript and election as to printing.

To Charles L. Spencer, Clerk of said Court:

In the above-entitled cause please make and forward to the clerk of the United States Circuit Court of Appeals, Eighth Circuit, at St. Louis, Missouri, as and for a transcript of the record on the writ of error from said Circuit Court of Appeals, copies of the following papers:

Complaint, summons, stipulation amending complaint, demurrer, record of hearing on demurrer, order overruling demurrer,
17 judgment for plaintiff, bill of exceptions, assignment of errors and prayer for reversal, petition for writ of error and order allowing same, and this præcipe and election.

The defendant herein files this, his notice of election to take and file said transcript in said Circuit Court of Appeals, and that the same be printed under the supervision of the clerk of said Circuit Court of Appeals, under its rules.

Dated February 5, 1916.

ALFRED JAQUES,
United States Attorney and Attorney for Defendant.

(Endorsed:) Filed in the District Court on Feb. 5, 1916.

Citation.

To Henry Turrish, plaintiff above named:

You are hereby cited and admonished to be and appear in the United States Circuit Court of Appeals for the Eighth Circuit of the United States, at the city of St. Louis, Missouri, sixty days from

and after the date this citation bears date, pursuant to a writ of error filed in the clerk's office of the United States District Court, District of Minnesota, Third Division, wherein Henry Turrish is plaintiff and E. J. Lynch, collector of internal revenue for the district of Minnesota, is defendant, to show cause, if any there be, why the judgment rendered against the defendant and in said writ of error mentioned should not be corrected, and why speedy justice should not be done the parties in that behalf.

Witness, the Honorable Wilbur F. Booth, judge of the United States District Court, this 5th day of February, 1916.

WILBUR F. BOOTH,
District Judge.

Due service of the foregoing citation and receipt of copy thereof is hereby admitted this 7th day of February, 1916.

CLAPP & MACARTNEY,
H. OLDENBURG,
H. J. RICHARDSON,
Attorneys for Plaintiff.

(Endorsed:) Filed in the District Court on Feb. 7, 1916.

Clerk's certificate to transcript.

I, Charles L. Spencer, clerk of the United States District Court for the District of Minnesota, do hereby certify and return to the honorable, the United States Circuit Court of Appeals, Eighth Circuit, that the foregoing, consisting of 31 pages, numbered consecutively from 1 to 31, is a true and complete transcript of all the
18 records, process, pleadings, orders, judgment, and all other proceedings in the within entitled cause, and of the whole thereof, as appears from the original records and files of said court, and in accordance with a præcipe for such transcript, a copy of which is included therein; and I do further certify and return that I have annexed to said transcript and included within the paging the original citation, together with the admission of service thereof.

In witness whereof I have hereunto set my hand and affixed the seal of said district court, at St. Paul, in said district, this 10th day of February, A. D. 1916.

(Seal U. S. Dist. Court, Dist. of Minnesota, Third Division.)

CHARLES L. SPENCER, *Clerk.*

Filed Feb. 12, 1916. John D. Jordan, clerk.

Writ of error.

UNITED STATES OF AMERICA, *ss:*

The President of the United States of America to the honorable the judges of the District Court of the United States for the District of Minnesota, Third Division, greeting:

Because, in the records and proceedings, as also in the rendition of the judgment of a plea which is in the said district court, before you,

at the December term, 1915, thereof between Henry Turrish, plaintiff, and E. J. Lynch, collector of internal revenue, defendant, manifest error hath happened, to the great damage of the said E. J. Lynch, collector of internal revenue, as by his complaint appears,

We, being willing that error, if any hath been, should be duly corrected and full and speedy justice done to the parties aforesaid in this behalf, do command you, if judgment be therein given, that then, under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the United States Circuit Court of Appeals for the Eighth Circuit, together with this writ, so that you have the said record and proceedings aforesaid at the city of St. Louis, Missouri, and filed in the office of the clerk of the United States Circuit Court of Appeals, for the Eighth Circuit, on or before the 5th day of April, 1916, to the end that the record and proceedings aforesaid, being inspected, the United States Circuit Court of Appeals may cause further to be done therein to correct that error, what of right and according to the laws and customs of the United States should be done.

19 Witness, the Honorable Edward D. White, Chief Justice of the United States, this 5th day of February, A. D. 1916.

Issued at office in St. Paul, Minn., with the seal of the District Court of the United States, for the District [or] Minnesota, Third Division.

CHARLES L. SPENCER,
Clerk of the District Court of the United States for the District of Minnesota.

(Seal U. S. Dist. Court, Dist. of Minnesota, Third Division.)

Allowed by WILBUR F. BOOTH, *Judge.*

Filed February 5, 1916. CHARLES L. SPENCER, *Clerk.*

UNITED STATES OF AMERICA,
District of Minnesota, Third Division, ss:

In obedience to the command of the above writ I herewith transmit to the United [Stated] Circuit Court of Appeals for the Eighth Circuit, a duly certified transcript of the record and proceedings in the within-entitled cause, with all things concerning the same.

In witness whereof, I hereunto subscribe my name and affix the seal of the District Court of the United States for the District of Minnesota, Third Division.

CHARLES L. SPENCER,
Clerk of the District Court of the United States for the District of Minnesota.

(Seal U. S. Dist. Court, Dist. of Minnesota, Third Division.)

Filed Feb. 12, 1916. JOHN D. JORDAN, *Clerk.*

20 And thereafter the following proceedings were had in said cause, in the Circuit Court of Appeals, viz:

Appearance of counsel for plaintiff in error.

United States Circuit Court of Appeals, Eighth Circuit.

E. J. LYNCH, COLLECTOR, ETC., PLAINTIFF IN ERROR,
vs.
HENRY TURRISH. } No. 4651.

The clerk will enter my appearance as counsel for the plaintiff in error.

ALFRED JAQUES,
United States Attorney, District of Minnesota, Duluth, Minn.

(Endorsed:) Filed in U. S. Circuit Court of Appeals, Feb. 28, 1916.

Appearance of Mr. Harold J. Richardson as counsel for defendant in error.

The clerk will enter my appearance as counsel for the defendant in error.

HAROLD J. RICHARDSON.

(Endorsed:) Filed in U. S. Circuit Court of Appeals, Mar. 22, 1916.

Appearance of Messrs. Clapp & Clapp as counsel for defendant in error.

The clerk will enter my appearance as counsel for the defendant in error.

N. H. CLAPP.
A. W. CLAPP.

21 (Endorsed:) Filed in U. S. Circuit Court of Appeals, Mar. 23, 1916.

Appearance of Mr. H. Oldenburg as counsel for defendant in error.

The clerk will enter my appearance as counsel for the defendant in error.

H. OLDENBURG,
Carlton, Minn.

(Endorsed:) Filed in U. S. Circuit Court of Appeals, Apr. 6, 1916.

Order of submission.

MAY TERM, 1916.
Saturday, May 13, 1916.

This cause having been called for hearing in its regular order, argument was commenced by Mr. Alfred Jaques for plaintiff in error, continued by Mr. A. W. Clapp for defendant in error, and concluded by Mr. Alfred Jaques for plaintiff in error.

Thereupon, this cause was submitted to the court on the transcript of the record from said District Court and the briefs of counsel filed herein.

22 *Opinion.*

United States Circuit Court of Appeals, Eighth Circuit.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE for the district of Minnesota, plaintiff in error, vs. HENRY TURRISH, DEFENDANT IN ERROR.	No. 4651, September term, A. D. 1916.

In error to the District Court of the United States for the District of Minnesota.

Mr. Alfred Jaques, U. S. attorney, appeared for plaintiff in error.

Mr. A. W. Clapp (Mr. N. H. Clapp, Mr. H. Oldenburg, and Mr. Harold J. Richardson were with him on the brief) for defendant in error.

Before Sanborn, Adams, and Carland, circuit judges.

Statement.

This writ of error was sued out to reverse a judgment which the plaintiff below, Turrish, recovered against Lynch, the collector, for the return to him of $127.12, which the collector had assessed against him as an additional income tax under the tariff act of October 3, 1913, c. 16, sec. II, 38 Stat., 166; 3 U. S. Comp. Stat., 1913, secs. 6319, 6320, 6321, and which he had paid under protest. The facts were alleged in the plaintiff's complaint and admitted by demurrer. The Payette Lumber and Manufacturing Company was a corporation organized in 1903 with a capital stock of $1,500,000 divided into 15,000 shares of the par value of $100 each, of which Turrish owned, in 1913 and 1914, 799¼ shares of the par value of $79,975. The Payette Company began immediately after its organization in 1903 to invest its capital in timber lands in the State of Idaho, and
23 prior to March 1, 1913, it had invested $1,375,000 thereof therein and the remainder thereof in other assets the ownership of which was incidental to the owning, holding, and preservation of the timber lands. During this time it did no business except

such as was incidental to the ownership and care of these lands, and it made no dividends or payments of any kind to its stockholders. On March 1, 1913, the Payette Company still owned all the property and assets it had invested its capital in, and the value of these assets was not less than $3,000,000. The increase in the value of its property was due entirely to the gradual increase in the value of its timber lands between 1903 and March 1, 1913, and the value of the stock of Mr. Turrish was then twice its par value, or $159,950. In March, 1913, Mr. Turrish and all the other stockholders of the Payette Company gave an option in writing to purchase their stock for twice its par value. The holders of this option formed another corporation, to which they transferred their option, and that company preferred to purchase the property of the Payette Company to purchasing its capital stock. Thereupon, in December, 1913, that company offered to sell all its property to the Boise-Payette Company, the new corporation which held the option to purchase its stock, for $3,000,000 in cash on condition that the new company would assume its debts and liabilities. The offer was accepted, and in March, 1914, the transaction was consummated. The Payette Company then had no assets but the $3,000,000 in cash and no liabilities not assumed by the Boise-Payette Company. It then distributed the $3,000,000 among its stockholders, who surrendered their stock, and the corporation has since been dormant. In the distribution of the proceeds of the property of the company Mr. Turrish received $159,950, which was twice the par value of his stock. The Commissioner of Internal Revenue deemed one-half of this sum, or the par value, and the actual value in 1903, of the stock of Turrish, capital returned to him, and the other half, or the increase of the actual value of his stock between 1903 and March 1, 1913, by reason of the gradual advance during that time in the value of the timber lands of the Payette Company, income derived by him in 1914 from a dividend received from a domestic corporation subject to the income-tax law. On this ground he assessed against Turrish an additional income tax of $127.12 on account of the second half of the $159,950. Turrish paid this tax under protest and brought this action for the return of the amount he paid. The court below was of the opinion that no part of this $159,950 was income taxable under the act of October
24 3, 1913, and it accordingly overruled the demurrer and rendered judgment for the plaintiff.

Sanborn, Circuit Judge, after stating the case above, delivered the opinion of the court.

Is the amount in excess of the par value, and of the actual value of his stock in 1903, derived by a stockholder of a domestic corporation subject to the income-tax law (38 Stat., 166, c. 16, Sec. II; 3 U. S. Comp. Stat., 1913, secs. 6319, 6320, 6321), exclusively from the increase in the value of his stock prior to March 1, 1913, the effective date of that act, on account of the gradual advance in

the value of the property of the corporation prior to that date, but first realized by him in cash by the distribution in 1914 by a dividend to all the stockholders of the corporation of all the proceeds of the sale in March, 1914, of all the property of the corporation, income, gains, or profits of the stockholder taxable under that law? The negative answer to this question seems at first to be reasonable (1) because no income, gains, or profits accrued to the stockholder during the year 1914, or after March 1, 1913; his property remained of the same value and gained nothing during that time, and (2) because the sale of the property of the corporation in 1914 and the distribution of its proceeds to the stockholders was a mere change of the form, without increase of the value, of the property he owned before the income-tax law took effect. Counsel for the United States, however, contend that the $79,975 which measures the increase in the value of the stock of the plaintiff between 1903 and March 1, 1913, derived from the gradual advance during that time of the value of the timberland of the corporation is taxable as his income (1) because he had no interest in the increased value of the property of the corporation until the dividend which distributed the proceeds of the sale of its property was declared in 1914, (2) because upon this distribution and not before he first obtained an interest in this increased value and thus in 1914 for the first time, it became income to him, and (3) because this $79,975 was derived from a dividend received by him in 1914. To sustain the first two contentions counsel invokes the general rule that a stockholder has no legal title or right to the income, gains, or profits of his corporation until the dividends of that income, or of those gains or profits, have been declared, and cites Hyatt v. Allen, 56 N. Y., 553, and like cases in support of that rule. But the tax authorized by the act under consideration is an annual tax on the income, gains, or profits arising or accruing after March 1, 1913, in the calendar year preceding the levy, and neither the rule itself nor any rational application of it is determinative of the question in what year this alleged income accrued or arose, or of the question whether the proceeds of the dividend were income or capital. If it were, then the entire $159,950 would, by the same mark, have become his income, gains, and profits when the distribution was made in 1914, for it was all distributed to him by the same dividend, and until that dividend was declared he had no better legal title or right to any of the property of the corporation or to the proceeds of any of it than he had to the increased value of its timberland.

It is true that a corporation holds the legal title of, and the right to manage, control, and convey its property and that a stockholder is without that title and right. But, after all, the corporation is nothing but the hand or tool of the stockholders in which they hold its property for their benefit. They are the equitable and beneficial owners of all its property and it is the mere holder and manager of it for them. The benefit of every increase in the value of its property is their benefit and the injury of every decrease of the value of its

property is their injury. They may by appropriate action at any time require and compel it to sell all its property and to distribute its proceeds among them, and may thus strip it of all its capital, all its income, surplus, gains, and profits and leave it penniless. So in reality, as against its stockholders, a corporation has no, and they have all the beneficial interest in its property. Every substantial increase in the value of its property immediately and proportionately increases the actual value of their stock and every substantial decrease of its value immediately and proportionately decreases the actual value of their stock. Whether the value of the property of a corporation is increased by a gradual advance through a series of years of the value of the same real or personal property held throughout, or by undivided income, gains, or profits the actual value of its stock is immediately and proportionately increased and the holders of that stock may at any time convey their respective beneficial interests in that enhanced value in those undivided profits and in all the other property of the corporation by sale, gift, or devise. The Collector v. Hubbard, 12 Wall., 1. The
26 position that a stockholder in a corporation has no interest in the enhanced value of its property or in its undivided income, gains, profits, or surplus until a dividend thereof is declared is untenable and may not prevail.

It is admitted by the demurrer that in this case the value of the property of the corporation increased solely by reason of the advance in the value of its timber lands from $1,500,000 in 1903 to $3,000,000 on March 1, 1913, that the value of the stock of the plaintiff from the same cause proportionately increased from $79,975 in 1903 to $159,950 on March 1, 1913, and that no further increase of value, gain, income, or profit resulted before or by reason of the sale of all the property of the corporation in March, 1914, and the distribution of its proceeds among its stockholders.

The income-tax law of 1913 provides: "That there shall be levied, assessed, collected, and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year a tax of 1 per cent per annum." Par. A, Sub. 1.

"In addition to the income tax provided under this section (herein referred to as the normal income tax) there shall be levied, assessed, and collected upon the net income of every individual an additional income tax (herein referred to as the additional tax) of 1 per centum per annum." * * * "All the provisions of this section relating to individuals who are to be chargeable with the normal income tax, so far as they are applicable and are not inconsistent with this subdivision of Paragraph A, shall apply to the levy, assessment, and collection of the additional tax imposed under this section." Par. A, Sub. 2.

"That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid,

or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent." Par. B.

27 After specifying the exemptions and deductions allowed in the computation of the net income for the purpose of levying the normal tax the law declares that:

"The said tax shall be computed upon the remainder of said net income of each person subject thereto, accruing during each preceding calendar year ending December thirty-first: Provided, however, That for the year ending December thirty-first nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen, both dates inclusive."

All the value of the property of the corporation and all the value of the stock of the plaintiff, whether it was due to capital assets, or income, or gains, or profits, or all of these combined, had arisen and accrued and had become their property before March 1, 1913. Words in a statute ought not to be given a retrospective operation unless they are so clear, strong, and imperative that no other meaning can be annexed to them or unless the intention of the legislature can not be otherwise satisfied. United States v. Burr, 159 U. S., 78; United States v. American Sugar Co., 202 U. S., 563, 577. The provisions of this law that the normal tax shall be levied annually upon the net income arising or accruing in the preceding calendar year, that so far as this case is concerned all the provisions relative to the levying of the normal tax shall apply to the levying of the additional tax, that the normal tax shall be computed on the remainder of the net income of each person accruing during each preceding calendar year ending December 31st, except that for the year ending December 31, 1913, it shall be computed on the net income accruing from March 1st to December 31st, leave no doubt that the Congress intended to and did exclude from the burdens of the taxes it imposed by the income-tax act of October 3, 1913, all income, gains, and profits of every kind which had arisen or accrued prior to March 1, 1913. It clearly intended to leave and surely did leave all the income, gains, and profits which had accrued or arisen prior to that date whether they were in the form of divided or undivided surplus, income, gains, or profits as free from every income tax it imposed and as absolutely the property of their respective legal and equitable owners as was any of their original capital or property. Now, the subsequent change by sale, distribution, or otherwise of the form of property held on March 1, 1913, without thereby enhancing its value or causing any

28 gain, profit, or income to its holders, as from real to personal property, or from stock to cash, does not subject it to the in-

come tax because it produces no gain, profit, or income, it leaves the value of the property the same after as before the change. And as the sale of the property of the Payette Company in 1914 and the distribution of its proceeds to its stockholders by the dividend did not enhance the value of the property of the corporation or of the stockholders or produce any gain, profit, or income for them, but left the value of their property the same that it was before those transactions and the same as it was when the income-tax law took effect, the declaration and payment in 1914 of the dividend by which the proceeds of the sale of the property of the corporation were distributed to its stockholders did not transform the increased value of the plaintiff's stock which had accrued and arisen prior to March 1, 1913, into income, gains, or profits accruing or arising subsequent to that date and did not subject it to any income tax. Merchants Ins. Co. v. McCartney, 17 Fed. Cases 46, No. 9443; Bailey v. R. R. Co., 22 Wall., 604, 106 U. S., 109, 114; United States v. Smith, 27 Fed. Cases 1175, No. 16,341; Von Baumbach v. Sargent Land Co., 219 Fed., 31, 36, 37, 134 C. C. A. 649, 654, 655; Sargent Land Co. v. Von Baumbach, 207 Fed., 423, 430, 432, 434; Mitchell Bros. Co. v. Doyle, 225 Fed. 437, 439, 440; Doyle, collector, v. Mitchell Bros. Co., — C. C. A. —, — Fed. — (6th Circuit), filed June 30, 1916; Chicago, Bur. & Q. R. Co. v. Page, 1 Bliss. 461, 5 Fed. Cases 600, No. 2668; Reynolds v. Williams, 20 Fed. Cases 625, No. 11,734, 4 Biss. 108.

The third argument of counsel for the collector is that because paragraph B provides that: "The net income of a taxable person shall include gains, profits, and income derived * * * from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever," all surplus or undivided profits included in any dividend received after March 1, 1913, although they accrued and arose years prior to that date, are by these terms of the law subjected to the additional tax, and he cites in support of this conclusion, Van Dyke v. City of Milwaukee, 159 Wis., 460, 146 N. W., 812; and United States v. Cleveland, C. C. and St. L. Ry. Co., a decision of the District Court of Ohio filed February 28, 1916. Conceding that these two decisions sustain this proposition of counsel for the Government, they are not controlling and have not proved
29 persuasive. In Van Dyke's case Judge Barnes filed an able dissenting opinion which has proved more convincing and which is in accord with the decision of the Supreme Court in Gray v. Darlington, 15 Wall., 63, and with the weight of authority. It was, as we have seen, the general purpose of Congress and the general effect of the act of October 3, 1913, to impose an annual tax upon incomes, gains, and profits accruing subsequent to March 1, 1913, and to impose none upon those which accrued or arose before that date. The interpretation of the clause of the act under consideration which brings within its grasp all incomes, gains, and profits accrued before the effective date of the act which happen to form parts of dividends declared after that date flies in the teeth of the

general purpose and policy of Congress in enacting the statute, creates an exception to the general effect of the statute which is not clearly made by the act itself and constitutes a strained and unnatural construction. Such a construction should not be adopted unless the terms of the act imperatively require it. The natural and legal presumption is that Congress intended to treat all income, gains, and profits accruing prior to March 1, 1913, alike and as it excluded from the burden of the income taxes all such income, gains, and profits as accrued prior to March 1, 1913, that did not become parts of dividends declared after that date the presumption is that it intended to exclude those also. Not only is there nothing in the act to negative or overcome this presumption, but the terms of the law when carefully read sustain it. By the terms of the clause on which counsel relies the taxable net income there specified does not include all dividends received after March 1, 1913, or all proceeds of such dividends, but "gains, profits, and income derived" from dividends. The clause is treating of the net income on which the additional tax is to be levied. By subdivision 2, Par. A, all the provisions of the section relating to individuals who are chargeable with the normal income tax, so far as they are applicable and are not inconsistent with that subdivision, are made to apply to the levy, assessment, and collection of the additional tax. Two of the provisions of that section relating to individuals who are chargeable with the normal tax which are applicable to the levy, assessment, and collection of the additional tax and are not inconsistent with the provisions of subdivision 2 are (1) that there shall be levied, assessed, collected, and paid annually "upon the entire net income accruing from all sources in the preceding year a tax of one per centum per annum" and (2) that the tax shall be computed upon the remainder of net income "accruing during each preceding calendar year ending December thirty-first: Provided, however, That for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen." All these provisions of the act must be read and construed together, and when so read and interpreted there is no logical or rational way of escape from the conclusion that the "gains, profits, and income derived" from dividends charged with the additional tax by Par. B are the gains, profits, and income arising and accruing subsequent to March 1, 1913, derived from dividends, and those only. And the conclusion is that the proceeds of the enhanced value of the stock of the plaintiff which accrued and arose prior to March 1, 1913, from the gradual increase in the value of the timber land of the Payette Company, and which formed a part of the dividend made by that company in 1914, was not subject to the additional income tax under the act of October 3, 1913. This conclusion finds substantial support from another consideration. The words income, gains, profits are used in common parlance and as legal terms in contradistinction to capital, property, capital assets. The enhanced value

of the land or property of a corporation or of the stock of a corporation which slowly accrues through a series of years from the natural and gradual increase of the value of the timber land or other property which the corporation holds without trading is more analogous to property, capital, or capital assets than to income, gains, or profits. It is rather a growth, an increase of the property or capital assets than income, gains, or profits produced by the property. Adverting to the oft-quoted analogy declared by the Supreme Court of Georgia in Waring v. Savannah (60 Ga., 100), that "the fact is, property is the tree, income is the fruit; labor is the tree, income the fruit; capital the tree, income the fruit," the enhanced value of property from the slow and gradual increase of its value through a series of years is rather a growth of the tree than the production of its fruit. It is so inequitable, so unjust, so discriminatory, to treat such an enhanced value accruing through many years before the enactment of an income-tax law as the income, gains, or profits of the year in which it happens subsequently to be distributed that the following rule which is supported by the more forcible reasons and by the great preponderance of authority has become the established law in the Federal courts. The enhanced value of property which accrues
from the gradual increase in its value during a series of years
31 prior to the effective date of an income-tax law, although
divided or distributed by dividend or otherwise subsequent to that date, does not become income, gains, or profits taxable under such an act. Such enhanced value, like the property of which it is an outgrowth, and in which it inheres, becomes the absolute property of its legal and equitable owners before the effective date of the law, and as against such a law thereafter remains their capital assets. (Gray v. Darlington, 15 Wall., 63, 65, 66, 67; Sargent Land Co. v. Von Baumbach, 207 Fed., 423, 432; Von Baumbach v. Sargent Land Co., 219 Fed., 31, 36, 37, 134, C. C. A., 649, 654, 655; Gauley Mountain Coal Co. v. Hays, 230 Fed., 110; Industrial Trust Co. v. Walsh, 222 Fed., 437; Mitchell Bros. Co. v. Doyle, 225 Fed., 437, 439, 440; Doyle v. Mitchell Bros. Co., — C. C. A., —, — Fed., — (6th Circuit), filed June 3, 1916; Hudsons Bay Co., Ltd., v. Stevens, 25 L. I. R., 709, 5 Tax Cases, 424, 436, 438, 439; Tebrau (Johore) Rubber Syndicate, Ltd., v. Farmer, 47 Scot. L. R., 816, 5 Tax Cases, 658.)

Because no income, gains, or profits accrued to the plaintiff during the year 1914 or after March 1, 1913, but during that time his property remained of the same value, and because the sale of the property of the Payette Company in 1914 and the distribution of its proceeds by a dividend to its stockholders was but a change of the form without any increase of the value of the property he owned before the income-tax law of 1913 took effect, there was no error in the judgment below, and it is

Affirmed.

Filed September 4, 1916.

32 *Judgment.*

United States Circuit Court of Appeals, Eighth Circuit.

SEPTEMBER TERM, 1916.

Monday, September 4, 1916.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE FOR THE District of Minnesota, plaintiff in error,
vs.
HENRY TURRISH.
No. 4651.

In error to the District Court of the United States for the District of Minnesota.

This cause came on to be heard on the transcript of the record from the District Court of the United States for the District of Minnesota, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court, that the judgment of the said District Court, in this cause, be, and the same is hereby, affirmed with costs; and that Henry Turrish have and recover against E. J. Lynch, Collector of Internal Revenue for the District of Minnesota, the sum of Twenty Seven and 50/100 dollars for his costs in this behalf expended and that the same be paid in accordance with law.

September 4, 1916.

33 *Clerk's certificate.*

United States Circuit Court of Appeals, Eighth Circuit.

I, John D. Jordan, clerk of the United States Circuit Court of Appeals for the Eighth Circuit, do hereby certify that the foregoing contains the transcript of the record from the District Court of the United States for the District of Minnesota, as prepared and printed under the rules of the United States Circuit Court of Appeals for the Eighth Circuit, under the supervision of its clerk, and full, true, and complete copies of all the pleadings, record entries, and proceedings, including the opinion, had and filed in the United States Circuit Court of Appeals, except the full captions, titles, and endorsements omitted in pursuance of the rules of the Supreme Court of the United States, in a certain cause in said Circuit Court of Appeals, wherein E. J. Lynch, Collector of Internal Revenue for the District of Minnesota, was plaintiff in error, and Henry Turrish, was defendant in error, No. 4651, as full, true, and complete as the originals of the same remain on file and of record in my office.

I do further certify that on the sixth day of November, A. D. 1916, a mandate was issued out of said Circuit Court of Appeals in said cause, directed to the judges of the District Court of the United States for the District of Minnesota.

In testimony whereof I hereunto subscribe my name and affix the seal of the United States Circuit Court of Appeals for the Eighth Circuit, at office in the city of St. Louis, Missouri, this twenty-seventh day of February, A. D. 1917.

[SEAL.] JOHN D. JORDAN,
Clerk of the United States Circuit Court of Appeals for the Eighth Circuit.
By E. E. KOCH, *Asst. Clerk.*

34 In the Supreme Court of the United States, October term, 1916.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE, ETC., petitioner, *v.* HENRY TURRISH. } No. 964.

Stipulation as to return.

It is hereby stipulated by counsel for the parties to the above-entitled cause that the certified transcript of the record herein, now on file in the office of the clerk of the Supreme Court, may be taken as the return of the clerk of the Circuit Court of Appeals for the Eighth Circuit to the writ of certiorari issued herein.

JNO. W. DAVIS,
Solicitor General.
N. H. CLAPP,
A. W. CLAPP,
H. OLDENBURG,
Counsel for Respondent.

March 26, 1917.

(Endorsed:) No. 4651, E. J. Lynch, Collector of Internal Revenue, etc., Plaintiff in Error, vs. Henry Turrish. Stipulation as to return to writ of certiorari from Supreme Court, U. S. Filed Apr. 20, 1917, E. E. Koch, Clerk.

35 UNITED STATES OF AMERICA, *ss:*

The President of the United States of America to the honorable the judges of the United States Circuit Court of Appeals for the Eighth Circuit, greeting:

Being informed that there is now pending before you a suit in which E. J. Lynch, collector of internal revenue for the district of Minnesota, is plaintiff in error, and Henry Turrish is defendant in error, No. 4651, which suit was removed into the said Circuit Court of Appeals by virtue of a writ of error to the District Court of the United States for the District of Minnesota, and we, being willing for certain reasons that the said cause and the record and proceedings therein should be certified by the said Circuit Court of Appeals

and removed into the Supreme Court of the United Stat
36 do hereby command you that you send without delay to t
said Supreme Court, as aforesaid, the record and proceedin
in said cause, so that the said Supreme Court may act thereon as
right and according to law ought to be done.

Witness the honorable Edward D. White, Chief Justice of t
United States, the twenty-second day of March, in the year of o
Lord one thousand nine hundred and seventeen.

[SEAL.] JAMES D. MAHER,
Clerk of the Supreme Court of the United States.

37 *Return to writ.*

UNITED STATES OF AMERICA, *Eighth Circuit,* } ss:

In obedience to the command of the within writ of certiorari a
in pursuance of the stipulation of the parties, a full, true, and co
plete copy of which is hereto attached, I hereby certify that t
transcript of record furnished with the application for a writ
certiorari in the case of E. J. Lynch, Collector of Internal Reve
for the District of Minnesota, plantiff in error, vs. Henry Turri
No. 4651, is a full, true, and complete transcript of all the pleadin
proceedings, and record entries in said cause as mentioned in t
certificate thereto.

In testimony whereof, I hereunto subscribe my name and affix t
seal of the United States Circuit Court of Appeals for the Eigh
Circuit at office in the city of St. Louis, Missouri, this twenty-fi
day of April, A. D. 1917.

[SEAL.] E. E. KOCH,
Clerk of the United States Circuit Court of Appeals for the Eighth Circuit.

(Indorsed:) File No. 25794. Supreme Court of the United Stat
No. 964, October term, 1916. E. J. Lynch, Collector of Intern
Revenue, etc., vs. Henry Turrish. Writ of certiorari. Office of
clerk Supreme Court U. S. Received Apr. 24, 1917.
Filed Apr. 20, 1917. E. E. Koch, clerk.

38 (Endorsed:) File No. 25794. Supreme Court U. S. O
tober term, 1916. Term No. 964. E. J. Lynch, Collector
Internal Revenue etc., Petitioner, vs. Henry Turrish. Writ of
tiorari and return. Filed April 24, 1917.

O

In the Supreme Court of the United States.

OCTOBER TERM, 1917.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE for the district of Minnesota, petitioner,
v.
HARRY TURNER.
No. 421.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE for the district of Minnesota, petitioner,
v.
H. C. HOUSER.
No. 422.

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

MOTION BY THE UNITED STATES TO ADVANCE.

Comes now the Solicitor General, appearing on behalf of petitioner, and respectfully moves the court to advance the above-entitled causes for hearing on a day convenient to the court.

These are suits to recover income taxes paid under protest on the ground that the taxes were erroneously assessed and collected within the meaning of the act of October 3, 1913 (38 Stat. 166).

No. 421 presents the following question:

Where a company incorporated for the purpose of buying, holding, and selling timber lands invests all its capital in such lands or in timber on them ("stumpage"), and subsequently, after March 1, 1913, sells all such lands and "stumpage" for cash, and divides the proceeds among its stockholders in return for the surrender of their certificates of stock (though not dissolving formally in accordance with law), are the amounts so paid to the stockholders or any part thereof (and, if so, what part), income of said stockholders within the meaning of the act of October 3, 1913, 38 Stat. 166?

No. 422 presents the following question:

Where a company incorporated for the purpose of buying and holding timber lands and of manufacturing and selling lumber invests a part of its capital in timber lands or in timber on them ("stumpage"), and in the regular course of business uses said timber for producing lumber, charging against the manufacturing cost of the lumber the full value of the stumpage, and distributes the entire proceeds of the sale of its lumber, less ordinary expenses, to its stockholders, informing them that part is derived from the net profits, charging manufacturing with the full value of the timber, and part from the conversion of the timber itself, is the amount so claimed to be derived from the conversion of the timber, or any part thereof (and, if so, what part) income of the

stockholders within the meaning and intent of the act of October 3, 1913, 38 Stat. 166?

The questions are of importance to the Government in the collection of the revenues under the so-called "income tax" law and their solution by this court will determine the disposition of many similar cases now pending.

Notice of this motion has been served on opposing counsel.

JOHN W. DAVIS,
Solicitor General.

OCTOBER, 1917.

WASHINGTON : GOVERNMENT PRINTING OFFICE : 1917

In the Supreme Court of the United States.

OCTOBER TERM, 1916.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE, ETC., PETITIONER,
v.
HENRY TURRISH.
No.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF.

The Solicitor General, on behalf of Lynch, collector, prays for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Eighth Circuit in the above-entitled cause.

QUESTION INVOLVED.

Where a company incorporated for the purpose of buying, holding, and selling timber lands invests all its capital in such lands or in timber on them ("stumpage"), and subsequently, after March 1, 1913, sells all such lands and "stumpage" for cash, and divides the proceeds among its stockholders in return for the surrender of their certificates of stock (though not dissolving formally in accordance with law), are the amounts so paid to the stockholders, or any part thereof (and, if so, what part), income of said stockholders within the meaning and intent of the act of October 3, 1913, 38 Stat. 166?

STATEMENT OF CASE.

The Payette Lumber & Manufacturing Company was incorporated under the laws of Minnesota with power, *inter alia*, to buy, hold, and sell timber lands; with an authorized and paid in capital stock of $1,500,000 divided into 15,000 shares. The respondent, Turrish, became the owner of 799½ shares (R. 6). All of the company's capital was invested in timber lands, and in property appurtenant to such investment (*ib.*).

Prior to March 1, 1913, the company's investment had appreciated from natural causes to a value of $3,000,000, of which sum the timber lands constituted $2,875,000 (R. 7). On December 27, 1913, the stockholders authorized the sale of all the property, including franchises, to another company for $3,000,000 in cash, and, the offer having been accepted, on March 9, 1914, the vendee company paid the Payette Company said sum, and on the same date the board of directors of the Payette Company, by resolution, directed the distribution of this amount to its stockholders upon the surrender of their certificates (R. 8). Accordingly there was paid to Turrish on surrender of his stock $159,950, being twice the par value and the cost thereof (R. 6, 8). The Payette Company has had no assets and has been engaged in no business since, although it has never been formally dissolved (R. 8, 9).

After Turrish had made his return the Commissioner of Internal Revenue added thereto the sum of $122,551 as income received from domestic cor-

porations (R. 3). This sum included $79,750 of the amount received in the manner stated above from the Payette Company, being the difference between what Turrish paid for the stock and what he received, and it is this amount alone which is in dispute in this case (R. 6). The Court of Appeals held (236 Fed. 653) that none of this amount was income since it had all been in effect gained by Turrish prior to March 1, 1913, and had been income to him prior to that time, so that all that happened after March 1, 1913, was the distribution to him of capital or accrued income previously existing.

REASONS FOR THE ALLOWANCE OF THE WRIT.

1. The case is of great public importance because of the large effect its decision will have on the revenues of the Government as determining the proper method of income taxation on stockholders in companies which buy timber lands, allow them to appreciate from natural causes, and, selling at a favorable moment, divide the proceeds among their stockholders.

2. The Court of Appeals relied largely on its own decision in *Sargent Land Company* v. *Von Baumbach*, 207 Fed. 423, which was reversed by this Court on January 15 last (No. 286).

3. A stockholder has no income from shares of stock in a corporation until dividends are declared.

4. The decision of the Court of Appeals confuses capital and income, and either treats the tax as one

on capital or holds that no income can accrue under any circumstances where capital is converted.

5. The decision of the Court of Appeals is contrary to the principles laid down by this Court in *Brushaber* v. *Union Pacific R. R.*, 240 U. S. 1, and *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103.

BRIEF IN SUPPORT OF THE PETITION.

1. This case and its companion, *Lynch* v. *Hornby* (in which application for a writ of certiorari is submitted at the same time) have been selected by the great lumber interests of the West and Northwest as test cases to determine the proper method of income taxation upon stockholders in lumber companies. The *Turrish* case presents the phase of an investment in timber lands and stumpage with the intention of merely allowing the timber to appreciate in value from natural causes, and of selling it when conditions appear favorable. The *Hornby* case presents the phase of dividends from companies which, while owning their own timber lands and stumpage, are engaged in converting the timber into lumber, using continuously in this process their own timber, and thus, as it is claimed, depleting to that extent their capital. The cases are, therefore, of great public importance, not only because of the principles of law involved but also because of their large bearing on the revenues of the Government.

2. The Court of Appeals relied largely on its own decision in *Sargent Land Company* v. *Von Baumbach*, 207 Fed. 423, which, as stated above, was reversed by

this court on January 15 last. In so far as the corporation, the Payette Lumber Company, is concerned, the fair inference from the decision of this court is that, having invested its capital in timber lands for the very purpose of obtaining by sale the increased value thereof due to appreciation from natural causes, when such sale took place income accrued to it, and the depletion of capital could not be deducted as depreciation. In this respect timber plantations are like mines. They are cultivated, not with the idea of keeping the capital intact (as in the case of fruit orchards), but of finally distributing the capital as income, unless, of course, a portion of the income is set aside each year to plant new trees and thus keep the capital at an even level. *Kauri Timber Co., Limited*, v. *Commissioner of Taxes* (1913) A. C. 771; Morawetz on Corporations, 2 ed., sec. 442; *Lee* v. *Neuchatel Co.*, 41 Ch. D. 1; *Reed* v. *Head*, 6 All. (Mass.) 174. If the Payette Company had sold off portions of its timber annually, instead of selling it all at one time, or had leased it on a royalty basis with right in the lessee to remove the timber in the course of regular operations, the case of *Von Baumbach* v. *Sargent Land Company* would be directly applicable. It surely can not make any difference that, for its own interest and in accordance with the very end and purpose of its organization, it chose to sell all its timber at one time. The proceeds of such sale were nevertheless its gross income, and the depletion of capital could not be deducted as depreciation.

3. In so far as Turrish, the stockholder, is concerned, he had no interest in the property of the company as such which was liable to an income tax, until a dividend was declared. *Gibbons* v. *Mahon*, 136 U. S. 549; *Humphreys* v. *McKissock*, 140 U. S. 304, 312; *Savings Bank of Danbury* v. *Loewe*, No. 713 this term, decided Jan. 8. Whatever may be the case as to the corporation, therefore, *his* income did not accrue, or was not "derived from dividends," until March 9, 1914, when the directors acted and distributed the proceeds of sale. Such a principle might not apply to the ordinary cases of winding up a manufacturing, merchandising, or banking company whose purpose is to distribute profits leaving the capital intact, and where the capital is returned to the stockholders; but it does apply to a case where the sale of the assets of the company is the very object of its organization and continuance, and where the profits or accumulated surplus, therefore, are distributed at the winding up, either in whole or in part, instead of being taken annually. *Eyster* v. *Centennial Board of Finance*, 94 U. S. 500, 503, 504; *Lord* v. *Brooks*, 52 N. H. 72, 84.

4. The whole opinion of the Court of Appeals is unconsciously permeated with a confusion of capital and income. A somewhat lengthy citation will show this (236 Fed. 660):

> * * * The words "income, gains, and profits" are used in common parlance and as legal terms in contradistinction to capital, property, and capital assets. The enhanced

value of the land or property of a corporation, or of the stock of a corporation, which slowly accrues through a series of years from the natural and gradual increase of the value of the timber land or other property which the corporation holds without trading, is more analogous to property, capital, or capital assets than to income, gains, or profits. It is rather a growth, an increase of the property or capital assets, than income, gains, or profits produced by the property. Adverting to the oft-quoted analogy declared by the Supreme Court of Georgia in *Waring* v. *Savannah*, 60 Ga. 100, that "the fact is, property is the tree, income is the fruit; labor is the tree, income the fruit; capital the tree, income the fruit," the enhanced value of property from the slow and gradual increase of its value through a series of years is rather a growth of the tree than the production of its fruit. It is so inequitable, so unjust, so discriminatory to treat such an enhanced value, accruing through many years before the enactment of an income tax law, as the income gains, or profits of the year in which it happens subsequently to be distributed, that the following rule, which is supported by the more forcible reasons and by the great preponderance of authority, has become the established law in the federal courts. The enhanced value of property which accrues from the gradual increase in its value during a series of years prior to the effective date of an income tax law, although divided or distributed by dividend or otherwise subse-

> quent to that date, does not become income, gains, or profits taxable under such an act. Such enhanced value, like the property of which it is an outgrowth and in which it inheres, becomes the absolute property of its legal and equitable owners before the effective date of the law, and as against such a law thereafter remains their capital assets. * * *

Here is a statement that the act taxes income and not capital; that all of the appreciation which came to the company's property before March 1, 1913, was capital, and not taxable before that time as income; ergo, it must remain capital forever, although performing after March 1, 1913, the very service to the stockholders and bringing them the very income which they had contemplated when they made their investment. In brief, an investment in timber lands never can produce income, for, of course, the annual appreciation could not be treated as income either to the corporation or to its stockholders, and when the property is sold no income accrues during the year in which it is sold because its value had been attained by appreciation during prior years. This view is in effect contrary to the decision of the Court of Appeals of the Second Circuit in *Edwards* v. *Keith*, 231 Fed. 110, where it was held that though a right to the payment of commissions on renewal premiums accrued to an insurance agent prior to March 1, 1913, yet no income accrued to him until the commissions were actually paid.

5. The decision of the Court of Appeals is contrary to the principles laid down by this court in *Brushaber*

v. *Union Pacific R. R.*, 240 U. S. 1, and *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, because it treats the tax as one upon a fund or property, and claims the right to go back of the actual receipt of income by the stockholders to the property which produced it, and decide the case by the manner of acquisition and nature of that property. This court held, in the two cases cited, that the Sixteenth Amendment did not create a new kind of a direct tax not subject to apportionment, but left the tax what it was, namely, an excise, merely prohibiting an inquiry into the property from which the income was derived in order to test its validity. The court therefore held in the *Brushaber* case that income accruing subsequent to March 1, 1913 (though before the passage of the act), could be taxed, although that income must have been to some extent derived from capital accumulated prior to March 1, 1913; and in the *Stanton* case, that the tax in its relation to mining companies was not a tax on their property, but an excise measured by the income derived therefrom. These decisions have been applied in the recent decision of the Court of Appeals for the Second Circuit in the case of Anthony N. Brady (not yet reported) who died July 22, 1913, before the passage of the Income Tax Act, but whose estate was nevertheless held liable. The court said:

> In our opinion the tax is against citizens and residents of the United States personally. They are chargeable in respect to income received by them. The statement that the tax is upon this income does not create an obli-

gation *in rem*. It is only a way of saying that the owner is taxable with reference to the income. Taxable persons are spoken of throughout the act.

The tax upon Turriah, therefore, was an excise upon him personally with respect to the income derived from dividends coming to him during the year 1914, and the nature of the property from which said dividends came, whether accumulated surplus, natural appreciation, or annual gains was immaterial. This was the holding of the Supreme Court of Wisconsin as to the income tax law of that State in *Van Dyke v. Milwaukee*, 159 Wis. 460, (which the Court of Appeals declined to follow—236 Fed. 655, 659). It is not the property which counts, nor when it was acquired, but the service performed by it—the income, gains, or profits accruing from it—during the taxing year.

CONCLUSION.

It is submitted that the writ should issue as prayed so that this court may give plenary consideration to the important questions here involved.

JOHN W. DAVIS,
Solicitor General.

FEBRUARY, 1917.

O

Office Supreme Court, U. S.
FILED
MAR 2 1918
JAMES D. MAHER,
CLERK.

United States Supreme Court.

OCTOBER TERM, 1917.

No. 421.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA,

Petitioner,

vs.

HENRY TURRISH,

No. 422.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA,

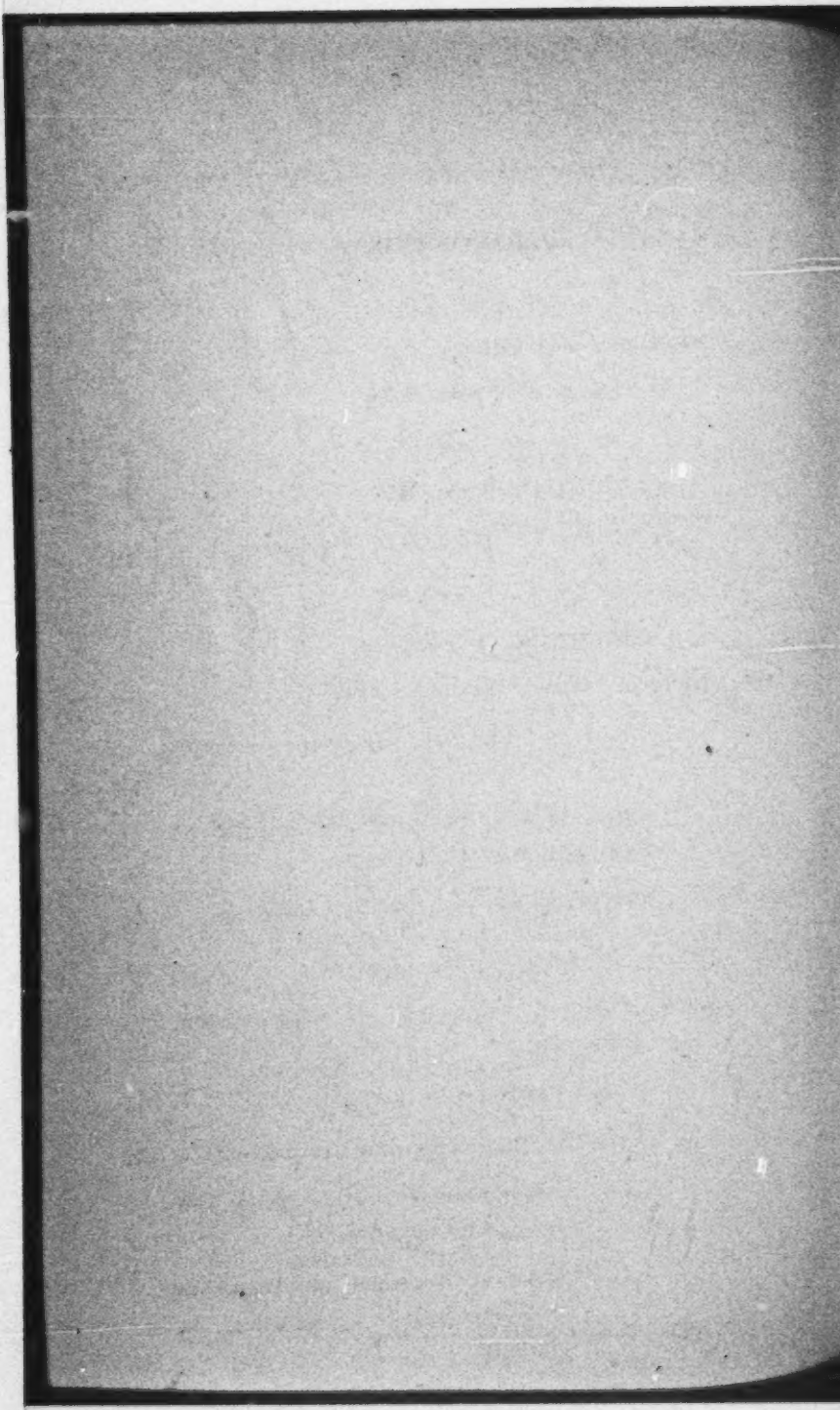
Petitioner,

vs.

H. C. HORNBY.

BRIEF FOR RESPONDENTS.

N. H. CLAPP,
A. W. CLAPP,
H. OLDENBURG,
H. J. RICHARDSON,
Atorneys for Respondents.



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United States Supreme Court.

OCTOBER TERM, 1917.

No. 421.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA,

Petitioner,

vs.

HENRY TURRISH,

No. 422.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA,

Petitioner,

vs.

H. C. HORNBY.

BRIEF FOR RESPONDENTS.

While the facts in these two causes are somewhat dissimilar, they involve the same general question of law, the

issues in each case requiring the construction, interpretation and application not only of the same statute—the Income Tax Law of 1913—but of that law in the same aspects and particulars. It therefore appears that rather than to submit separate briefs, which would, aside from the mere statement of the facts, of necessity largely duplicate each other, it will better subserve the convenience of the Court, as well as all parties interested, if one brief is filed to stand as the brief of the respondent in error in each of the two cases.

The petitioner demurred to the complaint in each case on the ground that the complaint did not state facts sufficient to constitute a cause of action (R. P. 12 in No. 421 and R. P. 14 in No. 422). The demurrers were overruled (R. P. 13 in No. 421 and 14 in No. 422). The petitioner failed to answer and judgment was entered for the respondent in each case (R. P. 13 in No. 421 and R. P. 15 in No. 422). Upon appeal to the Circuit Court of Appeals for the Eighth Circuit, these judgments were affirmed (R. P. 28 in 421 and R. P. 24 in No. 422). The opinions (R. P. 20 in 421 and R. P. 21 in No. 422) are reported in 236 Fed. 653 and 661. The cases are in this court on writs of certiorari.

I.

STATEMENT OF FACTS.

A. *Common to Both Cases.*

The pleadings are comparatively long, not only because it was thought desirable to state the facts fully, but also because it was necessary to allege a number of facts which are either formal jurisdictional facts, or circumstances which are, under the statutes, a prerequisite to the right to sue. No objection is made to the sufficiency of the pleadings with regard to these jurisdictional and preliminary facts. These allegations are found in each complaint in paragraphs I to VII inclusive (R. P. 1-6). We shall therefore confine our statement to those facts only which relate to the merits of the controversy. In each case the tax which was assessed and paid, under protest, was one which was imposed by the Commissioner of Internal Revenue upon certain receipts by the respective respondents in the year 1914, which were considered by the Commissioner to constitute taxable income. The allegations of each complaint clearly demonstrate that if the particular receipts in question were not taxable income then neither of the respondents would have been subject to the tax which was actually imposed, or to any part thereof.

In both cases the receipts over which the controversy arises consist of only one item, and a statement of the nature and source and time and manner of payment of these receipts, will be a sufficient statement of the facts upon which the issues of law in these cases arise.

B. *Material Facts in Turrish case* (421).

Mr. Turrish was in the years 1913 and 1914 a stockholder in Payette Lumber & Manufacturing Company. The capital stock of that Company was $1,500,000.00, divided into 15,000 shares of the par value of $100.00 each. Of these shares Mr. Turrish was the owner of 799¾ shares, of the par value of $79,975.00 (R. P. 6). The company had been organized for the purpose of engaging in the manufacturing business, and with that intention it purchased a large amount of timber land in the State of Idaho. As incidental to its right to invest in, own and hold real property and timber lands, it had of course the right to sell, *but the Company was not one organized for the purpose of buying and selling lands as a business, nor did it ever engage in such a business.* (R. P. 6 and 12.)

The Company was organized in 1903, and immediately began investing its capital in timber lands in the State of Idaho. Prior to March 1st, 1913, it had so invested approximately $1,375,000.00, and all of the remainder of its capital it had invested in other assets, the ownership of which was incidental to and connected with the owning, holding and maintaining of said timber lands. During all of the time in question, the Company did no business except such as was incidental to and connected with the ownership of its timber lands, and of course during that period it had declared no dividends, and made no payments of any kind to its stockholders (R. P. 6, 7).

On March 1st, 1913, the Payette Company still owned all of the property in which it had invested, and at that time the value of its assets had increased over the original cost and was not less than $3,000,000.00, of which sum the value of the timber lands was not less than $2,875,

000.00. The increase in the value of its capital assets was occasioned entirely by the gradual rise in the market value of the timber lands in which the Company had invested, and not at all by any dealings therein or use thereof by the company, or by virtue of any business done by the company. On March 1st, 1913, the value of Mr. Turrish's stock was twice its par value, or $159,950.00 (R. P. 7).

In the month of March Mr. Turrish, and indeed all of the stockholders of the Payette Company, gave an option in writing to sell their stock for twice its par value. This option, while extended from time to time until December 31, 1913, was never exercised in that form. The holders of the option formed another company, called Boise-Payette Lumber Company, and transferred the options to it, and that company preferred not to purchase the stock of the Payette Company, but to purchase all of its assets. In December, 1913, the Payette Company made a definite offer to the new company to sell all of its assets for $3,000,000.00 in cash, provided the new company would assume all the debts and liabilities of the Payette Company (R. P. 7).

The Boise-Payette Company accepted the offer of the Payette Company for the sale of its assets, in March, 1914, and the transfer was consummated in that month. The Payette Company, after the consummation of the transaction, had no assets or property except the $3,000,000 in cash, and no liabilities of any kind except such as had been assumed by the Boise-Payette Company, which was perfectly responsible. The Payette Company therefore had available for distribution to its stockholders, if it decided to go out of business, $3,000,000, and as a matter of fact, the decision was made to go out of business and

the $3,000,000 was distributed to the stockholders pro rata, the stockholders surrendering their certificates for stock (R. P. 8). The distribution was called a distribution, and not a dividend, but whatever name was given to it, or whatever form it took, we think immaterial, so long as the actual facts are understood.

After the distribution, the Payette Company engaged in no business whatsoever, but it had not up to the time of the commencement of this suit been legally or formally dissolved (R. P. 8).

Of the distribution of the $3,000,000, Mr. Turrish received $159,950.00, which was his pro rata share of the entire sum, and was exactly twice the par value of his shares (R. P. 8). The Commissioner of Internal Revenue considered that of this entire sum received in the year 1914, one-half of it, or $79,975.00, was not taxable because it was a liquidation to the amount of the par value of the plaintiff's stock, but that the remainder, $79,975.00, was income to Mr. Turrish for that year, which was taxable under the Act of 1913 (R. P. 9). If the Commissioner was right, and if this entire sum was taxable as income for the year 1914, then the tax in question was properly and lawfully assessed. If, under the law, the receipt of the sum in question did not constitute taxable income, then the judgment in favor of defendant in error should be affirmed.

C. *Material Facts in Hornby Case* (422).

Mr. Hornby was in the year 1914, and has been for a number of years, a stockholder in Cloquet Lumber Company, which is an Iowa corporation doing business in the State of Minnesota. It is a lumber manufacturing com-

pany, which has for thirty-one years been engaged in the business of manufacturing and selling lumber at Cloquet, Minnesota. The Company owns timber and timber lands, and from these timber lands, and of this timber, it cuts logs from year to year, which it manufactures into lumber (R. P. 6).

Its capital stock is $1,000,000, divided into 10,000 shares of the par value of $100 each. Of this capital stock Mr. Hornby was the owner in 1913 of 434 shares of the par value of $43400. Of these shares he acquired 154 many years ago, at their par value, but 280 were purchased by him on or about January 1st, 1906, for $350 per share (R. P. 6).

A large part of its original capital was many years ago invested by the Company in timber lands and standing timber, the value of which had greatly increased from the time of their purchase until March 1st, 1913. In the early years of its existence, and of its business, the Company paid no dividends and made no distributions to its stockholders, but instead re-invested all of the profits made by it in the business, and all of the money which was realized by it in the process of converting its standing timber into lumber and selling the same for money, in other timber lands and in other assets connected with and incidental to its business, including the capital stock of other corporations engaged in a like business. These assets also increased in value after their purchase, and on March 1st, 1913, the Company was possessed of assets other than undivided profits, consisting of property used or to be used in its business or connected therewith of the fair and actual market value of not less than four times the par value of its capital stock. A considerable

part of the property and assets which had been so acquired by the company and which were owned by it on March 1st, 1913, consisted of timber lands and timber, and of $110,000 par value of the capital stock of Johnson-Wentworth Company, also a lumber manufacturing company, which is described particularly hereafter (R. P. 6-7).

On March 1st, 1913, the standing timber or stumpage which was owned by the Company, had a market value as standing timber or stumpage, and this market value on that date was not less than $10.00 per thousand feet. On March 1st, 1913, the capital stock of the Johnson-Wentworth Company owned by the Cloquet Company was of the real and actual value of not less than $400,000, or nearly four times its par value (R. P. 7).

On March 1st, 1913, the value of Mr. Hornby's stock in the Cloquet Company was not less than $150,000.00, although its par value was $43,400.00 (R. P. 7).

In the year 1914, the Cloquet Lumber Company was in the process of liquidation. Since March 1st, 1913, and for several years prior thereto, the Company has purchased no standing timber, for the reason that there is none available which can be purchased and logged by the Company in its present location. In the years 1913 and 1914, and for several years prior thereto, it was the business policy and intention of the company to make no new investments either in timber or otherwise, but to distribute to its stockholders as fast as its standing timber and other capital assets were converted by it into money, the monies received therefor, in addition to whatever profits were made from year to year in its business. Its active business must necessarily cease within the next five or six years (R. P. 7, 8).

The Cloquet Company in 1914, in the course of its business, had a total net profit and income of $242,318.27. In that year, however, the company received monies available for distribution to its stockholders other than its said net income and profit, amounting to the sum of $410,000.00 (R. P. 8). This latter sum was realized and received by the company from two sources, which are particularly described in the complaint, and which are as follows:

Of the total sum of $410,000.00, $358,000.00 was realized by the Company from a conversion into money of a part of the standing timber owned by the Company on March 1st, 1913, and at the beginning of the year 1914. The process of this conversion was the cutting of the logs from the land, the sawing of the logs into lumber, and the sale of the lumber. The complaint alleges with some particularity, possibly with too much detail, the manner in which the bookkeeping of the Company reflected this conversion of its capital assets. The method of its accounting or bookkeeping is material only so far as it shows that the Cloquet Company had and actually used a system which disclosed at the end of the business year accurately and without question, the respective amounts of monies which it had received during the year, (a) by reason of the disposition or conversion of its capital assets on hand at the beginning of the year, and (b) by reason of profits made from the use of its capital assets in its business of manufacturing and selling lumber. The allegations of the complaint with reference to the stumpage perhaps may be summed up by saying that the market value of the stumpage consumed each year, obtained by multiplying the actual straight and sound scale of the logs cut from its

land by the unit value of $10.00 per thousand feet, was charged by the Company into its manufacturing cost for the year. The profits realized in its business after so charging up the value of its stumpage were profits of the Company for the year in its business of manufacturing lumber, and as the lumber was sold, there would be of course realized, along with this profit, the amount which the company had charged for its consumed stumpage (R. P. 8). This latter sum was in the Company's hands of course simply a changed form of part of its assets; instead, for instance, of 40,000,000 feet of standing timber worth $10.00 per thousand feet, which it had at the beginning of a year, the Company would have at the end of the year so much less timber, and $400,000.00 in money. Perhaps it may not be improper to say that this method of accounting is not peculiar to the Cloquet Company, or to any district or section of the country, but is the universal method of accounting in order to determine the real annual profits of lumber companies; and it is almost unnecessary to say that it is a method not devised to meet the requirements or evade the provisions of any excise, income, or other law, but is a proper and necessary business method which has been in use for many years.

We have mentioned above the ownership by the Cloquet Company of $110,000 par value of the capital stock of Johnson-Wentworth Company. The ownership of this stock was another source from which the Cloquet Lumber Company received money in the year 1914. The Johnson-Wentworth Company is also a lumber manufacturing company, engaged in the business of manufacturing lumber at Cloquet. It had been in existence and doing business for more than twenty-five years. Without going again

into detail as to the operation of this Company, it may be said that its history and status in 1914 was similar to that of the Cloquet Company, except that it owned practically no other assets than its standing timber and plant. Its standing timber was of the same unit market value as that of the Cloquet Lumber Company, and of course in its operations in the year 1914, it also consumed a portion of its capital assets, to-wit, a portion of its standing timber, and by the process of cutting its timber and converting it into lumber and selling the lumber, realized in the course of a year a large amount from this conversion of its standing timber. It had the same accounting methods as the Cloquet Lumber Company, and the result of its operations for the year 1914 was that it received in money as net profits and income, calculated in accordance with the above method, $159,362, and also realized over and above its net profits and income a sum exceeding $104,000 out of the conversion by it into money of standing timber owned by it for a number of years. During the year 1914, the Johnson-Wentworth Company distributed to its stockholders $160,000 out of its profits for the year and undivided profits carried over by it from the previous year, and also distributed to its stockholders pro rata, the said further sum of $104,000. The Cloquet Company, being the owner of one-half of the capital stock of the Johnson-Wentworth Company, received a total distribution of $132,000 of which the sum of $80,000 was so paid out of the earnings of the Johnson-Wentworth Company, and $52,000 out of monies realized by the Johnson-Wentworth Company out of its capital assets. The value of the stock of the Johnson-Wentworth Company which was owned by the Cloquet Company, which was based upon the value of

the assets owned by Johnson-Wentworth Company, was by this payment of $52,000 reduced by the amount of the payment, because just so much of the capital assets of Johnson-Wentworth Company had been disposed of during the year. The Cloquet Company credited the sum of $80,000 received by it from the earnings of Johnson-Wentworth Company, to its profit and loss account, but did not treat its receipt of $52,000 as an earning or profit to it during the year. It will be noticed that the amounts received by the Cloquet Company from a conversion of its own physical assets, to-wit, $358,000, and from the Johnson-Wentworth Company as a result of the conversion of the latter's assets, $52,000 makes the total sum of $410,000, above and next hereinafter referred to (R. P. 9, 10, 11).

The Cloquet Lumber Company distributed to its stockholders in the year 1914, the total sum of $650,000. Of the said distributions the fact was and the company so informed its stockholders, including Mr. Hornby, that the sum of $240,000, or 24 per cent upon its capital stock, was distributed out of the net earnings and profits of the Company for the current period, and that $410,000, or 41 per cent was distributed out of monies realized during the year 1914 by the Cloquet Company out of the conversion by it of capital assets owned by it on March 1st, 1913, and of course also on January 1st, 1914 (R. P. 11).

As the owner of 434 shares, Mr. Hornby received as distribution of earnings of the Company as aforesaid, $10,416, and out of its distribution of amounts received for capital assets the sum of $17,794 (R. P. 11, 12). The sum of $10,416 was included by Mr. Hornby in his own income tax return for the year 1914, and he was taxed upon an income which included in its computation this

sum; said tax was paid by Mr. Hornby without protest prior to June 30, 1915, and is not in question here (R. P. 12).

Mr. Hornby, however, did not include in his income tax return the $17,794, treating that as a return to him of capital. The value of Mr. Hornby's stock was reduced by the payment of this $17,794 to him, to the amount of said payment. It is the said payment or receipt of $17,794 which gives rise to the dispute between the government and the defendant in error in this case. The Commissioner treated the sum as taxable income to Mr. Hornby during the year 1914 (R. P. 12). Unless the same was taxable income, then the tax which was assessed and paid and which is sought to be recovered in this action should not have been assessed (R. P. 12), and the judgment in favor of the respondent should be affirmed.

D. *Difference of Facts in Two Cases More Apparent Than Real.*

It will be seen that on their face the facts in the Hornby case (422) are different and more complicated than the facts in the Turrish case (421). This difference and complication, however, is more apparent than real. A statement of facts in the Hornby case would be very much more simple if it were not for the circumstance of the ownership by the Cloquet Lumber Company of stock in Johnson-Wentworth Company. Of the amount distributed to Mr. Hornby in the year 1914, by the Cloquet Company out of conversion of its capital assets, it is obvious from the general statement, and from the allegations of the complaint, that 358/410 was out of a fund realized by the company from a conversion of its own physical

assets, to-wit, its standing timber. As to this portion of the fund, the substantial similarity between Mr. Hornby's position and that of Mr. Turrish is plainly apparent. While in the Turrish case the Payette Company realized on its surplus by the sale of all of its assets, and in the Hornby case the Cloquet Company realized on only a portion of its surplus or its capital assets, and not by a direct sale, but by the consumption of them in its own business, nevertheless, it is on principle impossible to logically distinguish the operations. This will be realized more distinctly if we conceive of the course of business of the Cloquet Company to be what it really was. The Cloquet Company was really selling to itself stumpage at its market value, and without profit. Its books might have been kept so as to show its timber holding department separate from its manufacturing department entirely, and if that had been done, the timber holding department would have shown the receipt without profit of $10.00 per thousand feet for all timber sold to the manufacturing department, and the manufacturing department would have shown a purchase of raw material and a manufacturing profit. As the courts have so many times said, it is not the method of bookkeeping which controls in determining what is and what is not profit or income, but it is the fact, "the real nature of the transaction," the "substance and not the form," and the fact is that the substance of the Cloquet Company's transaction was a sale or disposition of a portion of its capital assets. Viewed in that light, its transactions differ from those of the Payette Company only in the fact that the Payette Company disposed of all of its assets, while the Cloquet Company, in the process of a slower liquidation, disposed of only part.

Of the receipts by Mr. Hornby which are in dispute, ($17,794 in all), 52/410 was realized by Cloquet Lumber Company, not out of the conversion of its own timber, but by a partial liquidation of its stock in Johnson-Wentworth Company. The relation between Cloquet Lumber Company and Johnson-Wentworth Company is the same in this regard as between Mr. Hornby and Cloquet Lumber Company, that is, one was a stockholder in the other. If the court holds, as we contend, that when a corporation sells or disposes of, or consumes, and by any of those processes converts into money, capital assets owned by it at the inception of an income tax law, and passes that same fund over to its stockholders, receipt by the stockholders of their pro rata part of that fund does not constitute as to them, taxable income, then we think there is no difficulty, and that there will be no objection from the government, in carrying that doctrine to its logical conclusion, and holding that as the fund of $52,000 received from Johnson-Wentworth Company by the Cloquet Company did not constitute as to it income or earnings for the year, the passage of this same fund over to its own stockholders could not constitute taxable income as to them. While therefore the facts in the Hornby case are somewhat involved, we think that the same principles which may be held to govern the Turrish case will be found to be determinative of the Hornby case in all of its aspects.

II.

QUESTIONS WHICH ARE INVOLVED AND HOW THEY ARISE.

These suits were brought by the Respondents to test the correctness of the ruling of the Commissioner of Internal Revenue that the respective distributions made to them in the year 1914 as above described, were "gains, profits and income * * * derived from * * * dividends," and taxable as such under the Act of October 3, 1913, 38 Stat. 166. This ruling was based upon a general ruling or regulation known as "Treasury Decision No. 2163," the substance of which is as follows:

"TREASURY DEPARTMENT.

OFFICE OF COMMISSIONER OF INTERNAL REVENUE.

Washington, D. C., February 18, 1915.

To Collectors of Internal Revenue:

Cash dividends, or their equivalent, paid from the net earnings or the established surplus or undivided profits of corporations, joint stock companies or associations, and insurance companies, if declared and paid on or after March 1st, 1913, constitute taxable income in the hands of shareholders or beneficiaries when received, and should be returned when the total net income of any individual is in excess of $20,000 inclusive of such dividends, and the additional tax should be paid thereon as on income for the year in which such dividends were received, without regard to the period in which the profits or surplus were earned or the period during which they were carried as surplus or undivided profits in the treasury, or on the books of the corporations, etc. * * *

Treasury Decision 2048 of November 12, 1914, is hereby revised; and all rulings or parts of rulings

heretofore made which are in conflict herewith are hereby revoked.

Respectfully,

W. H. OSBORN,
Commissioner of Internal Revenue.

Approved:
W. G. McADOO,
Secretary of the Treasury."

The Government, however, in both the District Court, and in the Circuit Court of Appeals, has insisted:

First, that the fund from which the distribution in question in each case was made was "gain, profit and income" arising and accruing in the year 1914 to the respective corporations making the distributions, and that therefore it necessarily follows that when distributed to the stockholders in 1914, the same fund was income "arising and accruing" in that year to the stockholders, and

Second, that even if the funds from which the distributions were made were not income to the corporations in the year 1914 (or at any time subsequent to March 1, 1913—the effective date of the income tax law of 1913), nevertheless, as the moneys received by the respondents in the year 1914 by reason of these distributions, were *dividends*, they were "gains, profits and income" to the respondents in that year.

With respect to the first of these contentions, it must be observed that it is not based upon the Rules and Regulations or the rulings and decisions of the Secretary of the Treasury in force at the time the taxes in question were assessed. On the contrary, the Treasury Department had uniformly, by its formal rules and regulations, construed

and administered the Act of October 3, 1913, as not imposing a tax upon the gross receipts from the sale or other conversion of assets (including timber); nor, in case such assets were acquired prior to the effective date of the Tax Law, upon the difference between those gross receipts and the initial cost; but only upon the difference between the gross receipts and the value of the assets on the effective date of the Tax Law. See the following Rules, Regulations and Treasury Decisions (which are reproduced in the Appendix and hereafter more particularly referred to):

T. D. 2090.
Regulations 33, Art. 108.
Regulations 33, Art. 109.
Regulations 33, Art. 110 (as amended by T. D. 2077)
Regulations 33, Art. 111.
Regulations 33, Art. 139.
Regulations 33, Art. 140.

In spite of these constructions, and this uniform administration of the law by the Administrative department, the government contended in the lower courts that as to the Payette Company (in 421) and the Cloquet Company (in 422), *the difference between the gross receipts* arising in the first case from the sale, and in the second from the conversion of the assets acquired by each long prior to March 1, 1913, and the *initial cost* of those assets, was "net income" to those corporations *in 1914*, and that in as much as the complaints do not disclose the "initial cost," it does not appear that the entire fund did not constitute income. In this court, the government has apparently changed its attitude and seems to contend that

the gross receipts were "net income" *in 1914* to the corporations, without deduction even for initial cost.

Of course no question of taxation of the corporations is involved in these cases, and therefore the first of the contentions of the government (upon which counsel seems to mainly rely) seems at first blush not to bear directly upon the issues of this case. Carrying this contention further, however, the petitioner says that if (in the Turrish case, 421) by reason of the sale by the Payette Company in 1914 of all of its assets for $1,500,000 more than it had paid for them many years before (although at no advance over their actual market value on March 1, 1913), that company received "gains, profits and income" * * * "arising and accruing" in the year 1914 amounting to $1,500,000, then the fund so received, being income to the company in that year, the distribution to the stockholders in 1914 was a dividend out of the current earnings of that year, and would be taxable to the respondent Turrish.

We shall follow the sequence of argument chosen by the government. In doing so the questions raised by the first contention of the government above referred to will be called the "Capital Assets Question," and the other the "Dividend Question." Our contentions are as follows:

Capital Assets Question.

A. *In computing, under the Act of October 3, 1913, the net income arising from the sale or other disposition of capital assets acquired before and owned on March 1, 1913, (the effective date of the law) the taxpayer should be allowed credit for the value of the assets on that date.*

B. *There is nothing in the nature of the lumber business which calls for the application of any different rule.*

C. *If proposition A is not correct, then the Income Tax Law purports and attempts to lay a tax on something which is not income, but capital, and such a tax is not a "tax on incomes" within the meaning of the 16th Amendment, but is essentially a direct tax on property, and as neither before nor since the adoption of the 16th Amendment has Congress had the power to levy a direct tax on property without apportionment, and as the present law does not in any manner apportion the tax which it so purports and attempts to levy, it is unconstitutional and void.*

DIVIDEND QUESTION.

*Extraordinary distributions by a corporation, in the form of dividends or otherwise, made out of monies realized from a final disposition and conversion into money at the value on the effective date of the law, of assets of the corporation then owned by it as an integral part of its business, and then constituting part of its capital or surplus, are not, within the meaning of the law, "gains, profits and income * * * derived from * * * dividends," and are not for that reason or any other, taxable income to the stockholder receiving the same.*

In all of these propositions (except the constitutional question, a decision on which was of course unnecessary if the other propositions are correct) the Respondents were sustained by both of the lower courts.

In discussing these questions we shall do so primarily as they arise under the facts in the *Turrish Case* (421) calling attention when it seems necessary or appropriate, to the significance of the discussion in relation to the facts which are peculiar to the *Hornby Case* (422).

Before taking up these main questions, however, we desire to call the attention of the Court to certain rules for the construction of statutes. These appeals involve primarily the construction of a statute, and the pertinency and importance of the following rules will be readily appreciated and their application easily perceived by the Court as the argument on the main question is developed.

III.

RULES OF CONSTRUCTION TO BE APPLIED.

1. *The general rule in reference to statutes imposing taxes is that they are to be strictly construed against the Government, and in case of any doubt as to their meaning, they are to be given a liberal construction in favor of those subjected to taxation. Courts should not extend the meaning of such laws beyond the clear import of the language used, and are not at liberty by construction or legal fiction to include subjects of taxation not clearly within the terms of the law.*

Swan & Finch Co. v. United States, 190 U. S. 143-146.
American, Etc., Co. v. Worthington, 141 U. S. 468.
Benziger v. United States, 192 U. S. 38-55.
Eidman v. Martinez, 184 U. S. 578
United States v. Isham, 17 Wall. 504.
Spreckles Sugar Co. v. McClain, 192 U. S. 397-416.

In Gould v. Gould (decided at this term, November 19, 1917), this court, in a case involving the construction of the same statute here involved, said:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions,

by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen. *United States v. Wigglesworth*, 2 Story 369; *American Net and Twine Company v. Worthington*, 141 U. S. 468, 474; *Benziger v. United States*, 192 U. S. 38, 55."

The rule has been applied by the Federal Courts in construing the Corporation Excise Tax of 1909, with particular reference to the meaning of the term "net income."

Mutual Benefit Assn. v. Herod, 198 Fed. 199.

Pennsylvania Co. v. N. Y., Etc., Co., 198 Fed. 774.

Forty-two Broadway Co. v. Anderson, 209 Fed. 991.

And its particular applicability to the construction of the Income Tax Law of 1913 is emphasized by the Attorney General of the United States in his letter to the Secretary of the Treasury, dated July 15, 1914, (Corporation Trust Co. Income Tax Service, 1916 Edition, page 162), construing a doubtful provision of this law. He says:

"The intention of Congress to impose a tax must be expressed in 'clear and unambiguous language.'"

(Citing a number of the cases cited above.)

2. *Where a particular construction of a statute will occasion great inconvenience or produce an inequality or injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute.*

A good example of the application of this rule is seen in Knowlton v. Moore, 178 U. S. 41, from the language of which we have taken our statement of the rule. That was a case which involved the construction of the inheritance tax provision contained in the Act of June 13, 1898

Aside from the question of the constitutionality of the tax, the particular question in the case was whether the Act should be construed as imposing a tax upon the whole estate of the decedent, and applying the exemption of $10,000.00 to the net estate as one transfer, or whether the tax should be considered as assessed against each legacy or distributive share, in which case, the exemption of $10,000.00 would apply to each share. There was no doubt in the minds of the Court that Congress had the *power* to tax either the entire transfer or each legacy or distributive share. That the question was a very close one is evidenced by the dissenting opinions in the case. The majority, in reaching its conclusion, applied the rule, using the language given above. See also

Bates Refrigerating Co. v. Sulzberger, 157 U. S. 1, 37.
Wilson v. Rousseau, 4 Howard 646, 680.
Bloomer v. McQuewan, 14 Howard 539, 553.
Blake v. National Banks, 23 Wall. 307, 320.
United States v. Kirby, 7 Wall. 482, 486.

3. The third rule which we believe to be particularly applicable in these cases, in view of the contentions made by the Government, is one which is stated thus by this Court, in United States v. American Sugar Co., 202 U. S. 563, 577:

> "We are to remember there is a presumption against retrospective operation, and we have said that words in a statute ought not to have such operation 'unless they are so clear, strong, and imperative, that no other meaning can be annexed to them, or unless the intention of the Legislature cannot be otherwise satisfied.' United States v. Burr, 159 U. S. 78."

IV.

CAPITAL ASSETS QUESTION.

A. *In computing, under the Act of October* 3, 1913, *the net income arising from the sale or other disposition of capital assets acquired before and owned on March* 1, 1913, *(the effective date of the law) the taxpayer should be allowed credit for the value of the assets on that date.*

Our contention is that the law of 1913 applied to and took effect on business conducted after March 1, 1913; that business (of the kind disclosed by these records) is conducted with property, and so the law took effect on the body of property existing on that date and upon the business thereafter conducted by and with the aid of that property. That property was the capital which must produce the future income (which was all that was to be taxed), and a mere change in the form of that capital at its then value could not produce "net income" "arising and accruing" after March 1, 1913.

(a) *The language of the law.*

In the first place, it will be noted that in the law (Par. A) net income is defined to be *"gain, profit and income derived,"* etc. The word "and" as thus used, is equivalent to "as well as."

Bouvier's Law Dict. Rawles 3rd Rev. 194.
Porter v. Moores, 4 Heisk 16.
City of La Salle v. Kostka (Ill.) 60 N. E. 72.
Lipton v. People (Ill.) 40 N. E. 638.
Rice v. U. S., 53 Fed. 910.

"In accordance with the maxim *noscitur a sociis*, the meaning of a word used in a statute must be construed in connection with the words with which it is associated. Where several words are connected by a copulative conjunction, they are presumed to be of the same class, unless a contrary intention appears."

36 Cyc. 1118 and cases cited.

See, also,

Black Interpretation of Laws, 2nd Ed. 194.

Broom's Legal Maxims, 593.

The rule, as applied to the particular law under discussion, is thus stated by Black (Income Taxes, 2nd Ed. Sec. 219), 1913 Ed. Sec. 31:

"The meaning of a doubtful word or phrase may be ascertained by reference to the meaning of other words or phrases with which it is associated, and that, where several things are referred to they are presumed to be of the same class when connected by a copulative conjunction, unless a contrary intent plainly appears. * * * If it is doubtful whether or not a particular fund or acquisition is taxable as 'income' under the statute, it is not taxable unless it is income in the nature of 'gain' or 'profit.' If any item is clearly included in the description of 'gains' yet it is not taxable unless it is a gain in the nature of 'incomes' or 'profits.' And although the disputed item may be certainly a 'profit' in one sense of the word, yet it is not taxable unless it be a profit accruing by way of gain or income."

In Southern Pacific v. Lowe, 238 Fed. 847, Judge Manton said:

"I do not think that 'income', as used in the statute, should be given a meaning so as to include everything that comes in. The true function of the words 'gains' and 'profits' is to limit the meaning of the word 'income' and to show its use only in the sense of receipts which constituted an accretion to capital. So

> the function of the word 'income' should be to limit the meaning of the words 'gains' and 'profits.' The increased value of capital as such constitutes in one sense a gain or profit, but not income. Hence such gain or profit is not taxable, but only such profits and gains as constitute income are taxable. This in substance was what the court held in Gray v. Darlington, 15 Wall. 63, 21 L. Ed. 45, and in Gauley Mountain Coal Co. v. Hays, 230 Fed. 110, 144 C. C. A. 408."

Moreover, what is taxed under the law is "the entire net income *arising or accruing* from all sources in the *preceding calendar year.*" (Par. A.) In other words, the tax is upon *annual income,* and the words "arising or accruing in the preceding calendar year" should be read into Paragraph B, so that it would read, "the net income of a taxable person shall include gains, profits, and income, arising and accruing (n. b. not received) in the preceding calendar year, and derived from sales," etc.

And in Par. D it is provided that

> "For the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen, both dates inclusive."

(b) *Ordinary meaning of "income" in business world.*

Boiled down to plain terms, the government's contention in the lower courts with respect to Capital Assets was this: If two persons, A and B, each owned on January 1st, 1913, corner lots opposite each other, each of the lots being worth $50,000, A having purchased his in 1883 for $5,000, and B having purchased his on January 1st, 1913, for $50,000, and if each should sell his lot during the year 1913 for $50,000, then A would be considered to

have received in 1913, gains, profits and income arising and accruing during that calendar year, amounting to $45,000, and would be taxable on the same, while B would not be considered to have received any income.

Looked at simply from the viewpoint of the ordinary business man, this contention contravenes the generally accepted meaning of the word "income." And the usual and generally accepted meaning of any term or word is not to be overlooked in construing a statute. Perhaps it is not too much to say that no general conception of taxable income would endure, and that no law based thereon would be capable of practical administration, which does not reasonably conform to the ordinary and popular idea of income. No business man would consider that of the two persons in the above illustration, A and B, the capital of A on January 1st, 1913, did not equal the capital of B, or that A, by his sale in the year 1913, made any gain, profit, or income in that year. On the other hand, it would be considered that each by his transaction of sale in the year 1913, was simply converting capital in one form, to-wit, real estate, into capital in another form, to-wit, money. The popular (business man's) notion would certainly be that if a tax were exacted upon $45,000 of the amount received by A, it would be in substance a tax, not upon A's income for the year 1913, but upon his capital. There is not a shadow of a doubt but what A's property was as much capital to him as B's property was to him. In this respect at least it may be said that popular conception agrees with that of every economist, every decision, and every known definition of capital.

A man's capital at any given point of time, applying the word with reference to property, is that which is then

"working" for him, and which he may expect to produce his future income. Capital may increase in two ways: first, by a natural and gradual increase in the value of the specific things which constitute the capital; and second, by the capitalization by the individual owner of income, gains, or profits which he receives from his capital. Whatever a man's property during the year produces for him, so that he may, if he wishes, use it and consume it without impairing or affecting his capital, is income. This income may be spent for living expenses, for pleasure, or may be dissipated, or may not be used at all, may never become capital, but if instead the individual elects to invest his income in other property to produce more income, then the fund which was income to him as it came in, becomes capital, and from that time on remains capital. The facts in the TURRISH CASE show that the increase in the capital of the Payette Company—that is, the increase in the value of its assets, as well as the increase in Mr. Turrish's capital, which was his stock, was an increase which occurred in the first manner. In the HORNBY CASE, it appears that the increase in the value of the capital or assets of the Cloquet Company, over and above the par value of its stock, and the corresponding increase in the value of Mr. Hornby's capital, which was his stock in the Cloquet Company, occurred through a combination of both methods. But whether capital increases in either one of these two ways, it is capital in the increased form, or at the increased value, at any given time, for it is that from which in the future the owner is to get his income.

Again alluding to the illustration given above, if A. (the man who purchased his property for $5,000 in 1883), should have sold it on February 28, 1913, for $50,000, got-

ten the money and gone across to the opposite corner and bought B's land for the same price, the government concedes that on March 1st, 1913, the $50,000 which he paid is his capital, and that it is only the income from, or future increase in, that capital which could be or was intended to be taxed by the income tax law. Assuming that both sales were at the real value, A's first property was worth as much to him, and as much his capital, as the money which he got for it, or as the second piece of property which he purchased. By none of his transactions on that date did he then increase his capital or capitalize something that was not capitalized already. Would the government admit that if instead of there being two sales, there had simply been an exchange of one piece of land for the other, the land which A receives in exchange was capital to him at its actual value, or would they consider that his capital was still $5,000.00? Of course, there is no real distinction between the cases, because the money exchange was simply measuring the value of each property in money.

(c) *With particular reference to Taxation of Incomes, there is a clear distinction between Capital and Income.*

Professor Seligman, in his work on "The Income Tax" (2d Ed. 1914, pp. 19-20), says:

> "At the outset of such a study it is desirable to secure a clear idea of what is meant by income. *Income is, of course, to be distinguished from mere receipts or gross revenue.* It is more than that which simply comes in from any economic activity. By income is always meant net income, as opposed to gross income. In other words, from the receipts in any enterprise we must, in the first place, deduct the expenses of the

enterprise—that is, the outlay incurred in securing the gross product. But secondly, income as a personal category differs from net product. If a debt has been contracted in order to secure the produce of a given piece of property or of a given enterprise, the interest on the debt must be deducted. Finally, in the outlays or expenses which have been incurred to secure the product there must also be included a compensation for wear and tear of plant; just as the investor in securities computes his actual income by deducting an amortization quota from the annual proceeds. *Income, therefore, always means net income.*

What has been stated is equivalent to saying that income is that which comes in to an individual above all necessary expenses of acquisition, and which is available for his own consumption. Since the income is a flow of wealth, it must always be estimated for a definite period, so that when we speak of income for purposes of taxation, we really mean annual income. Strictly speaking, income as contrasted with capital denotes that amount of wealth which flows in during a definite period *and which is at the disposal of the owner for purposes of consumption, so that in consuming it, his capital remains unimpaired.*"

Professor Seligman's work is not simply a discussion of income in the abstract sense, but of the basic principles of income taxes, particularly with reference to Federal income taxes in the United States.

As we have shown, the word "income" in the Act of 1913, must be taken to mean that income which is in the nature of gains or profits, as the three words are used conjunctively in the definition of income in the Act.

In McCullough, Principles of Political Economy, (4th Ed.) it is said:

"Profits really consist of the produce or its value remaining to those who employ capital in industrious undertakings, after all their necessary demands have been deducted *and after the capital wasted or used in the undertakings has been replaced.* * * *

> If the capital be merely replaced and there is no surplus, there will neither be loss nor profit."

Hon. James C. Carter, in discussing in 1894 the desirability and fairness of an income tax, says : (50 Albany Law Journal, page 300.)

> "A tax laid directly on property may and often does invade the principal sum, for it has to be paid whether the property has been producing or not; whereas a tax upon incomes *never invades the principal.*"

At this point perhaps it would be not inappropriate to call attention to the reasons which have always been given in support of the desirability and fairness of an income tax. In the first 18 pages of Professor Seligman's work (2d Ed. 1914), he gives a short resume of the fundamental problems of taxation, and says (on page 4) :

> "The history of finance, in other words, shows the evolution of the principle of faculty or ability to pay—the principle that each individual should be held to help the state in proportion to his ability to help himself."

And he points out that the principal argument in favor of an income tax is that of all of the different systems of taxation, the income tax most completely responds to this test of ability to pay, *because the tax does not fall upon wealth or property itself, but upon the annual produce of wealth.*

The Supreme Court of Wisconsin, in the Income Tax cases, 148 Wis. 456, 505, expresses the same distinction.

In Black on Income Taxes (written after the passage of the Act of 1913, and as an aid to its construction) Section 32, the author reviews numerous definitions of income, and concludes (p. 78) :

> "We conclude, therefore, that, for the purpose of an income tax, a proper definition of the word 'income' would be all that a man receives in cash during the year, *except such sums as are merely capital or principal in a changed form; that is, excluding sums which are merely the proceeds of some other form of capital converted into cash.*"

In Waring v. Savannah, 60 Ga. 100, the question was whether income was properly within the meaning of the constitutional provisions respecting the taxation of property. The court held that it was not property, saying:

> "The fact is, property is the tree, income is the fruit, labor is the tree, income the fruit; capital the tree, income the fruit. The fruit if not consumed as fast as it ripens will germinate from the seed which it encloses and will produce other trees and grow into more property, but so long as it is fruit merely and plucked to eat and consumed in the eating, it is no tree and will produce itself no fruit."

Judge Pitney, in Stratton's Independence v. Howbert, 231 U. S. 399, said:

> "For income may be defined as the *gain derived from* capital or from labor, or from both combined."

The late Judge Willard, in Sargent Land Co. v. Von Baumbach, 207 Fed. 430, said:

> "What does the word 'income' mean? In ordinary speech people recognize a difference between capital and income. I believe that the ordinary meaning attached to income, when it is not derived from personal exertion, is that it is something produced by capital *without impairing that capital, and which leaves the property intact*, and that nothing can be called income for the purpose of this Act *which takes away from the property itself.*"

In speaking of the English system of Income Tax Acts, it was said by Lord Chancellor Halsbury, in Council of India v. Scoble, A. D. 299; 72 L. J. K. B. N. S. 617:

"I think it cannot be doubted upon the language and the whole purport and meaning of the income tax acts, that it was never intended to tax capital as income, at all events.

(d) *Gradual increase in the value of property is Augmentation of Capital.*

Gray v. Darlington, 15 Wall. 63.

Gauley Mountain Coal Co. v. Hayes, 230 Fed. 110.

Southern Pacific v. Lowe, 238 Fed. 847.

Industrial Co. v. Walsh, 222 Fed. 437.

Mitchell Bros. v. Doyle, 225 Fed. 437.

Hudson Bay Co. v. Stevens, 5 Tax Cas. 424.

Tebrau Rubber Syndicate v. Farmer, 5 Tax Cas. 658.

Foster's Income Tax, Sec. 33.

Seligman, The Income Tax (2nd Ed.) pp. 681-2.

Gray v. Darlington, *supra*, arose under the income tax law of March 2, 1867 (14 Stat. 477, 478), which imposed a tax upon "the gains, profits and income of every person * * * whether derived from any kind of property, rents, interest, dividends, or salaries, etc., * * * *or from any other source whatever.*" The act provided that:

"In estimating the gains, profits and income of any person, there shall be included all income derived from interests upon notes, bonds and other securities of the United States, profits realized within the year from sales of real estate purchased within the year, or within two years previous to the year for which income is estimated, * * * and all other gains, profits and income derived from any source whatever."

The facts in the case were these, as stated in the opinion of the Court: In 1865 the plaintiff, being the owner of

certain United States treasury notes, exchanged them for United States 5-20 bonds. In 1869 he sold these bonds at an advance of $20,000 over the cost of the treasury notes, and upon this amount the assistant assessor of the United States for the Collection District within which the plaintiff resided assessed a tax of 5 per cent, alleging it to be gains, profits and income of the plaintiff for that year. The Court held that the advance in the value of the property during a series of years did not constitute gains, profits or income of any particular year of the series, although the entire amount of the advance was at one time turned into money by a sale of the property—that mere advance in value constituted and must be treated merely as increase of capital. The Court, after stating the facts, said:

> "The question presented is whether the advance in the value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits or income of the plaintiff *for the year in which the bonds were sold.* The answer which should be given to this question does not, in our judgment, admit of any doubt. The advance in the value of the property during a series of years can, in no just sense, be considered the gains, profits, or income of any one particular year of the series, *although the entire amount of the advance be at one time turned into money by a sale of the property.* The statute looks, with some exceptions, for subjects of taxation only to annual gains, profits, and income. Its general language is 'that there shall be levied, collected, and paid *annually* upon the gains, profits, and income of every person,' derived from certain specified sources, a tax of five per cent, and that this tax shall be 'assessed, collected, and paid upon the gains, profits, and income for the year ending the 31st of December, next preceding the time for levying, collecting, and paying said tax.' (14 Stat. at Large 477-8, Sec. 13.) This language has only one meaning

and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits as may be realized from a business transaction begun and completed during the preceding year. * * * (p. 65.)

The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.

The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten years, yet, if the amount received exceeds the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes place. We are satisfied that no such result was intended by the statute." (pp. 66-67.)

The same rule has always been followed in England. See

Hudsons Bay Co. Ltd. v. Stevens, 25 L. I. R. 709; 5 Tax Cases 424;

and particularly the language of the Master of the Rolls at page 436 (5 Tax Cases), of Farwell, L. J. at p. 438, and Kennedy, L. J. at page 439.

In Tebrau (Johore) Rubber Syndicate, Ltd. v. Farmer, 47 Scot. L. R., p. 816; 5 Tax Cases, p. 658, the commissioners imposed an income tax upon the profit derived from the sale of a rubber estate. The taxpayer appealed to

the Court of Exchequer (Scotland). Lord Salversen, delivering the opinion of the court, says (5 Tax Cases, p. 664):

> "In this case I am of opinion that the determination of the Commissioner is wrong. I am unable to distinguish the position of the appellants from that of a person who acquires a property by way of investment and who realizes it afterwards at a profit. It is well settled that in such a case *the profit is not part of the persons' annual income* liable to be assessed for income tax, but *results from an appreciation of his capital.* No doubt if it is part of his business to deal in land or investments, any profits which in the course of that business he realizes form part of his income; but the mere fact that a person or company has invested funds in the purchase of an estate, which has subsequently appreciated and so has realized a profit on his purchase, does not make that profit liable to assessment. * * *"

Again calling attention to the fact that the tax was imposed on *annual* income, he says:

> "The fallacy of the view taken by the Commissioners is further apparent from the fact that the profit which ultimately results from an appreciation of value is not necessarily referable to the particular year in which it is realized.
>
> In the case before us it is no doubt true that the Syndicate only existed a little more than a year, but that does not in the least affect the question whether the profits were made by way of annual income or resulted from an appreciation of capital. Suppose the company had been in existence for ten years before it sold its whole property at a profit. How could it be said that the profit so made was income of the last year in which it existed?"

In the case of Von Baumbach v. Sargent Land Company, 219 Fed. 31, it appears that the corporations in question sold in the years subsequent to the passage of

the Corporation Excise Tax Law, lots and lands conveyed to them, apparently without cost to the corporations, in 1906, and one of the questions in the case was whether the proceeds of these sales constituted income. The government contended that they did. Judge Sanborn said:

> "And it is not doubtful that the small amounts of money received by them from the sales of the lots and lands that were conveyed to them at their organization in 1906, were not income, *but were mere proceeds of parts of their property on account of which they could not be lawfully taxed.*"

On appeal, this court took pains to point out (242 U. S. at pp. 525-6) that this question was not urged and not decided.

Gray v. Darlington, *supra*, has been followed and applied in

Gauley Mountain Coal Co. v. Hays, *supra*.

Industrial Co. v. Walsh, *supra*.

Mitchel Bros. v. Doyle, *supra*.

(all cases involving the meaning of "net income" in the Corporation Excise Tax Act of 1909, 36 Stat. 112).

The principle of Gray v. Darlington has been recognized as correct, although not directly applied in

Doyle v. Mitchell Bros., 235 Fed. 686.

Biwabik Mining Co. v. U. S. 242 Fed. 11.

Cleveland C. C. & St. L. Ry. Co. v. U. S. 242 Fed. 18.

(also cases arising under the Corporation Excise Tax Act of 1909).

The principle is applicable to the determination of what is income under the Income Tax Act of Oct. 3, 1913, involved in this case.

Southern Pacific Co. v. Lowe, 238 Fed. 847.

And the decision in Gray v. Darlington seems to be applicable and controlling in these cases, so far at least as the "Capital Assets" question is concerned. The facts in the Turrish case (421) are almost precisely similar to the facts in Gray v. Darlington, because the property which was bought in 1903 and sold in 1914 by the Payette Company was acquired and held as, and always remained, an investment.

It will be observed that under the language in Gray v. Darlington, "augmentation of capital" by its gradual rise in value might be said *never* to constitute income, even for the period in which the rise occurred. It has been doubted (C. C. C. & St. L. Ry. Co. v. U. S. *supra*) whether the actual decision goes so far. But this is immaterial in these cases, because the complaints in each clearly show that there was no increase in the actual market value of the assets described in either case either during the taxable year or after the effective date of the tax law. And if an increase of capital caused by the rise in value of property which constitutes the capital is *ever income*, it must be income for the period in which the rise occurs.

So we may pass to a proposition which is supported without variance or doubt by the decisions of the courts of this country.

(e) *The said law (of Oct. 3, 1913) does not purport or intend to tax the increase in value of property of the taxpayer, occurring prior to the effective date of the Act (March 1, 1913) simply because that increased value is converted into money after that date.*

This is the construction which seems to have been uniformly given to *every* prior Federal income tax law, to

similar laws of states where the question has arisen, and to the Corporation Excise Act of 1909, which, it is true, did not tax income, but measured the tax imposed by the amount of "net income."

Decisions Under Act of 1909.

Cleveland C. & C. Ry. Co. v. U. S. 242 Fed. 18.
Doyle v. Mitchell Bros., 235 Fed. 686.
Biwabik Mining Co. v. U. S. 242 Fed. 11.
U. S. v. Guggenheim Ex. Co., 238 Fed. 231.
Mitchell Bros. v. Doyle, 225 Fed. 437.

Perhaps the best discussion of the question is found in Doyle v. Mitchell Bros., *supra*. It will be unnecessary to state the facts in the case, because it is before this court for argument at the same time as the present cases. The Mitchell Bros. Co. was engaged in the same business as the Cloquet Company in the Hornby Case (422) and one of the question was how to compute net income in the conversion and manufacturing of standing timber. The Mitchell Bros. Co. also sold permanent assets during the tax years in question, and in that respect the facts are more or less analagous to the transactions of the Payette Company in the Turrish Case (421). Among other things the court said:

> "It is clear that, by the term 'income' Congress did not intend to include the proceeds of capital assets sold or converted during the year; nor can it be material whether such proceeds are reinvested in other property or remain in the treasury of the company or are distributed to the stockholders; nor whether, in case of such distribution, they are called dividends or capital. The controlling question must be whether assets so converted were in fact, at the begin-

ning of the tax period, properly to be classed as capital assets. If they were of that character, they cannot be 'income' received during the later period; they represent merely capital in a changed form." * * *

"The law contemplates distinct periods. Everything before 1909 must be in one period; everything later in another; and then, for taxing purposes, each calendar year after that date forms a distinct subperiod; the law plainly contemplates that all income shall be definitely located somewhere. The law applied to and took effect upon business conducted after January 1, 1909; business is conducted with property; and so the law took effect upon the body of property existing at that date and upon the business thereafter conducted by and with the aid of that body of property. In the later successive years, and as to some classes of property, it may serve every purpose to delay the computation or entry of income or gains seemingly existing in one year until cash realization in the next, and to do this by carrying an arbitrary, but constant, inventory value; this will make no difference to taxpayer or to the government in the end; but not so with reference to the two main periods before and after the law took effect. In the sense in which we have seen 'income' is and must be used at the end of each taxing year, it must be used at the end of the period preceding 1909. Whatever would be income for 1909, if it accrued after January 1st, had become income on that day if it had accrued in the earlier period." * * *

"The true character of that particular accumulation on January 1, 1909, now involved, may be illustrated with reference to this corporation. To meet this $20 per acre increase in market value, the company could lawfully have paid out a cash dividend or a stock dividend, or it could have sold its property for the original value plus the appreciation and have distributed the entire proceeds. If this had been done on December 31, 1908, there would be no income in 1909. If the consummation were postponed for two days, upon no tenable theory could it be thought that the $20 appreciation would become part of the income produced by carrying on the business during

1909. We are satisfied that the necessary and practical working of the law requires, and that its words fairly permit, income for one year to be computed by the aid of a comparison between the market value of the body of property on hand at the beginning and at the end of the year; and it follows that such a market value of property existing at the commencement of the period must be deducted from the selling price afterwards received. We are speaking only of those business assets the manufacture and sale or the purchase and sale of which constitute the regular business which is being measured for taxation purposes—assets which were acquired and held for sale and are intended to be sold as soon as put in the selected selling form. Appreciation in assets intended for more permanent holding may or may not be governed by the same considerations." * * *

"There are three possible methods of treating such a business as this: (1) We may say that there is no income whatever, since the sale of capital assets determines their value in the raw material form and so nothing has been received except their fair prices; (2) we may say that the entire selling price of the assets is income when the money is received; or (3) we may say that the appreciation therein and gain thereupon during the period and found at its end in realizable form is income. The first or second definitions conform rather better to the ordinary meaning of the word, but they cannot be accepted. The first was held, in Stratton's Independence v. Howbert, 231 U. S. 399, 34 Sup. Ct. 136, 58 L. Ed. 285, to be erroneous and to involve a misapplication of Gray v. Darlington, 82 U. S. (15 Wall.) 63, 21 L. Ed. 45. The second is in conflict with the unbroken practice of the Treasury Department in administering this law, and in conflict with the assessment made by the Commissioner in this case; and we have pointed out some of the reasons why it cannot have been intended by Congress to be applicable to this kind of a business. The third is workable and practicable, and, as we think, the only fair interpretation."

In Cleveland C. C. & St. L. Ry. Co. v. U. S., 242 Fed. 18, *supra*,

the court held that on the sale of assets purchased in 1900 and sold in 1909 for a sum largely in excess of the purchase price, the only "net income" for the year 1909 was the difference between the market value on Jan. 1, 1909 (the date of the incidence of the law) and the sale price, and that the increase in value between the date of purchase and Jan. 1, 1909, was capital on the latter date, and could not be income of the year 1909 simply because converted into money.

Cases Arising Under War Income Tax Acts.

Bailey v. Railroad Co., 22 Wall. 604.
Same Case, 106 U. S. 109.
Merchants Insurance Co. v. McCartney, 17 Fed. Cas. 46.
U. S. v. Smith, 27 Fed. Cas. 1175.
Chicago, B. & Q. Ry. Co. v. Page, 5 Fed. Cas. 600.
Reynolds v. Williams, 20 Fed. Cas. 625.

All of these cases recognized and enforced the rule that *that which is capital at the inception of an income tax law* does not become taxable income when it is turned into its then value in money after the law becomes effective. These decisions being also applicable to the "'Dividend Question" will be again referred to and analyzed later in this brief.

Under Wisconsin Income Tax Law.

State v. Nygaard, 158 N. W. 87.

State v. Wisconsin Tax Com., 158 N. W. 89.

The following extract from the Nygaard Case is a sufficient statement of both these decisions:

"The income tax law (section 1087-ml, Stats. Wis. 1913) provides for the levying of a tax on 'incomes received during the year ending December 31, 1911, and upon incomes received annually thereafter,' and in subsection 2 of section 1087-m2 defines the term 'income.' Subdivision (d) of the last named subsection provides that the term 'income' shall include 'all profits derived from the transaction of business or from the sale of real estate or other capital assets; provided, that of the profits derived from the sale of real estate or other capital assets acquired previous to January 1, 1911, only such proportion shall be taxable as the time between January 1, 1911, and the date of sale bears to the entire time between the date of acquisition and the date of sale.' In the present case it appears without dispute that the relator, on January 1, 1911, owned stock, which he had purchased as an investment more than four years previously, which was of the value of $214,000, and that on February 20, 1914, he sold the same for $214,000. Upon these facts the court now reaches the conclusion that there is in fact no 'income' in the present case within the meaning of that word as used in the Constitution. The Constitution (section 1, art. 8) permits the taxation of 'incomes' and the statute (sections 1087-ml to 1087-m29, Stats. Wis. 1913) provides for the levying of a tax upon 'incomes' received during the year. The word 'income' has a definite, well understood meaning. No attempt was made to define it in the constitutional amendment for the reason that it carried its meaning with it. That meaning was and is the 'common, ordinary meaning' as the word is used in everyday life. Van Dyke v. Milwaukee, 159 Wis. 460, 146 N. W. 812, 150 N. W. 509. In brief, it may be said to be the profit or gain derived from capital or

labor or from both combined. Stratton's Independence v. Howbert, 231 U. S. 399, 34 Sup. Ct. 136, 58 L. Ed. 285; Income Tax Cases, 148 Wis. 456-513, 134 N. W. 673, 135 N. W. 164. It must be gain or profit, and it must be money, or something equivalent thereto. Income Tax Cases, supra. * * *

When the income tax law was first passed in 1911 the stock in question was held by the plaintiff, and was then of the value of $214,000. This fact is admitted to be established. In the judgment of the court all of this was capital or, in other words, property. Its status was fixed. No part of it could be made into income by legislative enactment. It was subject to taxation as property under the uniformity rule, but not otherwise."

The cases at bar are, so far as we know, the only ones as yet decided which involve, directly or indirectly, a construction of the Act of 1913 with reference to the "Capital Assets Question." The decision of both lower courts in this regard are in accordance with this long and widely established principle that income tax laws are prospective, that they operate on income arising after their passage, and that capital existing at that time does not become income merely because its form is changed.

(*f*) *The circumstances existing at the time of and surrounding the passage of the Act of 1913 show the intention of Congress to be as hereinabove stated.*

First: Congress, when defining net income in terms certainly not broader, in fact much less inclusive than, the definition of "Income" in the Civil War Income Tax laws, must be presumed to have known of the construction given by the courts to those acts, to-wit: that they were prospective merely, and did not tax capital existing at the date of the inception of the law when its

form was changed, or it was converted and distributed thereafter; and must therefore be held to have intended the Act of 1913 to bear the same construction.

Second: When the Act of 1913 was passed, the Corporation Excise Tax Act of 1909 had been in operation four years. During all of that time the Treasury Department, charged with the duty of administering that law, had held and ruled that increases in value of property up to Jan. 1, 1909 (the effective date of the law) were *capital* and did not thereafter become annual income when converted into money. See Treasury Decision No. 1571, dated Dec. 3, 1909 (reproduced in the Appendix at page v). See also Treasury Decisions 1588, dated January 24, 1910; No. 1606, dated March 29, 1910; No. 1675, dated February 14, 1911; No. 1706, dated June 9, 1911; No. 1727, dated August 25, 1911; No. 1742, dated December 5, 1911; Nos. 1754-5, dated January 22, 1912, and No. 1833, dated February 18, 1913.

Congress must necessarily have enacted the Act of 1913 in the light of these decisions by the Administrative Department, defining net income under similar language in an existing Act, and surely if it had been intended by the Act of 1913 to extend the meaning of taxable "net income," Congress would have made the intention plain by specific language.

Third: In the discussion and explanation in the House of Representatives, of the present bill (Congressional Record, April 26, 1913), Mr. Cordell Hull, its reputed author, stated:

> "In construing all these laws, unless the unearned increment is specifically made income, *it is not con-*

sidered income in any sense of the word, but simply increase of value or capital."

He also stated in response to questions, and in almost every form in which language could convey the thought, that it was not the intent of the bill to tax that which already existed as capital.

Mr. Hull was pressed still further on this point. He said:

> "My judgment would be that as to the occasional purchase of real estate, not by a dealer or one making the buying and selling a business, *this bill would only apply to profits on sales where the land was purchased and sold during the same year."*

Speaking of this debate and this "sale of assets" question, Dr. Seligman says (The Income Tax, p. 682):

> "As this section was adopted in the light of Mr. Hull's explanation, it is not unlikely that it will be so interpreted as to carry out the evident intention of its framers."

(*g*) *Construction of the Act of 1913 by the Treasury Department.*

Among the most familiar and most frequently applied rules of statutory construction is the rule that where the construction of a statute is doubtful, that which is given to it by the Administrative Department charged with its administration is entitled to great weight.

Subsequent to the passage of the Act of 1913, and in its rules, regulations and decisions formulated to aid in the administration of the law, the Treasury Department promulgated rules for the computation of net income in the case of sales of Capital Assets similar to those in force under the Excise Tax Act of 1909, and referred to above

See Regulation 33, Articles 108, 109, 110, 111 (Appendix, pp. ii, iii, iv), and Treasury Decision 2090 (Appendix, p. i). The latter is in part as follows:

> "*Profit* is the difference between the selling price and the cost where the selling price is more than the cost.
>
> * * * * * *
>
> The cost of property acquired subsequent to the incidence of the tax will be the actual price paid for it together with the expense incident to the procurement of the property in the first instance, and its sale thereafter, and the cost of improvement or betterment, if any.
>
> The entire profits realized by individuals or corporations from the sale of real estate will be taxable *except where the property in connection with which the profit is obtained was acquired prior to March 1, 1913, in the case of individuals, or prior to January 1, 1909, in the case of corporations;* and then and in such event the profit will be prorated over the whole time the property was held, and that part of the whole profit apportioned to the taxable period will be reported in annual returns of income. In prorating, fractional parts of years will not be considered."

It takes but little consideration to see that the principle upon which these rules and regulations are based, is that that cannot be treated or taxed as income, which represents an increase of value of assets, which occurred prior to the inception of the Tax Law. The "prorating" part of the rule is a rule of convenience of administration. It is based upon a presumption that the increase in value over a number of years is uniform, and that the value of property on the day when an income tax law comes into effect can be arrived at by prorating mathematically the whole increase in value, or profit, between the years before and since the inception of the law. With

the *principle* upon which these rules and regulations are based, we need not quarrel. The *administrative* feature of the regulations, to-wit: *The method of arriving at the value* at the inception of the law, is not, and does not pretend to be, a construction of the law, but is in fact, an arbitrary addition to the law, and is, for that reason, as we understand, repudiated by the Department of Justice. The Courts have also specifically condemned the "pro-rating" rule, except possibly as a rule of prima facie presumption, which must yield to the real facts whenever the latter appear.

Bailey v. R. R. Co., 106 U. S. 109.

Mitchell Bros. v. Doyle, 225 Fed. 437.

B. *There is nothing in the nature of the lumber business which calls for the application of any different rule than that stated in "A" hereinabove.*

Counsel for the government has taken in this court a position quite different from that taken in either of the lower courts. The contention now made seems to be that the *gross proceeds* of the sale or other conversion of timber are net income. We confess that it is difficult for us to determine from the government's brief whether any distinction is made between timber and other property. Apparently there is and apparently the contention is based upon, or perhaps it would be more accurate to say fostered by, the following assumptions, or premises, all of which seem to us to be quite false:

First: That the lumber manufacturing business is not to be classed with other manufacturing and like business, but with the mining business, as to which (it is assumed) special rules for ascertaining net income must be applied.

Second: that the decisions of the Circuit Court of Appeals in these cases were based upon the decision of the same court in

Von Baumbach v. Sargent Land Co., 219 Fed. 31,

which was reversed by this Court in 242 U. S. 503, partly on the authority of Stratton's Independence v. Howbert, 231 U. S. 399.

Third: that the decisions of this court in Von Baumbach v. Sargent Land Co., *supra*, Stratton's Independence v. Howbert, *supra*, and Stanton v. Baltic Mining Co., 240 U. S. 103, are applicable to the law of 1913, *and to the facts in these cases*, and

Fourth: still carrying out the supposed analogy between mining and manufacturing lumber, that such authorities as the following are pertinent:

Kauri Timber Co. Ltd. v. Com'r. of Taxes (1913). A. C. 771.

Coltness Iron Co. v. Black, 6 App. Cas. 315.

Insistence upon these assumptions strongly indicates that the government totally misconceives, and *therefore* unintentionally misrepresents, the nature of the business of manufacturing lumber. For this reason we think it would be well to point out and correct the fundamental error into which the Government has fallen, and to demonstrate that for the purpose of determining the annual gains, profits, and income of a lumber manufacturing business, that business is essentially on the same plane as any other manufacturing business; and that if, and insofar as, the mining business has characteristics which differentiate it from other business, the lumber business does not possess those characteristics.

The lumber business, like every other manufacturing business, consists of changing raw material into a commercial article ready for the consumer. Lumber is as finished a product as structural steel, dry goods, or flour. The raw material of the lumber manufacturer is the log—which is simply a tree felled. This raw material the manufacturer may and actually does, to a large extent, buy periodically—as annually—in the form of logs. Many units of the industry own no supply of raw material, but supply themselves by year to year buying, either of logs or of trees. Government timber on forest reserves, for instance, is sold in comparatively small lots, upon short term (often annual) contracts, at so much per "thousand feet, board measure" (the standard of measurement of quantity of logs). Manufacturers who own a supply of raw material (timber) of their own, almost invariably are supplementing that supply by periodical purchases of logs. The fact is that the lumber manufacturer procures his raw material just as does every other manufacturer, whenever and wherever he can most profitably do so. Experience has shown that generally speaking it is most profitable—in fact in some districts almost essential—that he purchase raw material enough to supply his factory for a number of years. Several factors have contributed to make this an economic advantage. Among them are these: the investment in plant, logging facilities and working capital are enormous in comparison with the value of the annual output, and thus it is advantageous to spread this "overhead" over an operation of from fifteen to twenty years; the raw material is of such a nature—its bulk and weight are so large when compared to value, that the manufacturer can seek his raw material only within

a certain radius of his mill; and the timber within that radius is absolutely limited by its initial stand, for in this country, with the prevailing tax systems, reforestration and even selective cutting of timber is a commercial impossibility for private owners. In practice, therefore, many lumber manufacturers acquire and own large bodies of standing timber; in other words, they buy raw material for a number of years in advance, so as to assure themselves of the requisite supply. This, however, does not change the essential nature of the business, any more than would the purchase by the steel manufacturer of several years supply of pig iron, or by the cotton goods manufacturer of several years' supply of cotton, change the essential character of *their* business. The primary and essential characteristic is not in the ownership or the exploitation or the working of land, but the manufacture of timber—logs into a useful commercial product.

The standing timber, which the lumberman has on hand at any given time, is as definite and as ascertainable in quantity and value as the goods on a merchant's shelves, or the pig iron stock pile of the steel mill, or the warehoused raw cotton of the cotton mill. The trees stand on the ground, visible, of a certain number, capable of exact measurement by the same standard of measurement as that at which they are charged into the cost of manufacture. The timber does not and cannot increase in quantity. There is no such thing in this country (commercially speaking) as a "timber plantation." One does not "grow" timber, or anticipate profit from growth. Such growth as there is, is offset by decay and occasional windfalls, etc.

Now, probably nobody had ever supposed (at least up to the time of the filing of the government brief in these

cases) that in ascertaining annual net income under the Act of 1913, the steel or cotton or other manufacturer should not have credit by deduction *in some way* for raw materials—capital—consumed in the operation during the year. And in (apparently) making a different contention as to the lumber manufacturing business, counsel has, we repeat, become confused by his misunderstanding of the business and misled into attempting to apply by analogy, decisions in mining cases.

Mining is a business *sui generis*. In practically all mining operations (except open pit iron ore mining) there is a dual function, discovery—exploration, and recovery—removal. The same shaft which may serve for the removal of a supposed body of mineral, at once serves the discovery or demonstration of that particular supposed body, and may and often does reveal the existence of others. The assets—the capital of the ordinary miner are always problematical, both as to quantity and as to value, and for this reason the business is probably the most speculative of all enterprises.

In Stratton's Independence v. Howbert, 231 U. S. 399, it was said:

> "The peculiar character of mining property is sufficiently obvious. Prior to development it may present to the naked eye a mere tract of land with barren surface and of no practical value, except for what may be found beneath. Then follow excavation, discovery, development, extraction of ores resulting eventually, if the process be thorough, in the complete exhaustion of the mineral contents so far as they are worth removing. Theoretically, and according to the argument, the entire value of the mine, as ultimately developed, existed from the beginning. Practically, however, and from the commercial standpoint, the value—that is, the exchangeable or market value—

depends upon different considerations. Beginning from little, when the existence, character and extent of the ore deposits are problematical, it may increase steadily or rapidly so long as discovery and development outrun depletion, and the wiping out of the value by the practical exhaustion of the mine may be deferred for a long term of years."

In Doyle v. Mitchell Bros. Co., 235 Fed. 686, Judge Denison says:

"Counsel for the collector rely upon a number of cases, mostly English, to support the proposition that where the business which is being carried on contemplates and necessarily involves a wasting of the capital assets, the proceeds of that wasting are entirely income. Of those cases, it is to be noticed that they are mostly mining cases, and that mineral out of sight, in the ground, forms a peculiar class of capital assets. It has no makret value because it cannot be measured, and neither quantity nor quality can be definitely known; it is predominantly speculative, and the difficulty of determining what is capital and what is income is very great; while this standing timber had at all times an easily ascertainable market price."

See also,

Coltness Iron Co. v. Black, 6 App. Cas. 315.

We call attention to these characteristics of the mining business, only because of counsel's almost complete reliance on mining cases. To be sure, he seems to have misinterpreted the scope of some of them.

Stratton's Independence v. Howbert, *supra*, held that mining was a business subject to the corporation excise tax of 1909; and that if (as was assumed) allowance for "depletion" should be made under that Act to determine net income, that allowance was certainly not the difference between gross sales price and the expense of removal and sale. The record in that case presented

the sole and extreme contention that there could never be an "income" in the mining business. It was that contention which this court answered; it could go no further on account of the state of the record.

In Von Baumbach v. Sargent Land Co., *supra*, this court again had before it a mining case arising under the Act of 1909. The court held, against the contention of the taxpayer, (which was a corporation receiving royalties under an iron mining lease) first, that it was engaged in business and therefore subject to the tax; second, that the instrument under which it was receiving "royalties" was a *lease* and not a *sale*, and therefore the entire amount of royalties was "income"; and third, that *the act of 1909* did not provide for the deduction of an allowance for depletion in such cases. The court certainly decided nothing inconsistent with the contention of the respondents in this case.

In Stanton v. Baltic Mining Co., *supra*, this court had before it, not the construction of the Act of 1913, but its constitutionality, and particularly the constitutionality of the clause in that act which *limited* by specific language the maximum depreciation allowance *in the case of mines*.

Now obviously none of these decisions are applicable to ordinary manufacturing business or to the ordinary sale and conversion of capital assets. In fact, the government's whole argument along this line is so patently and wholly inapplicable to the facts in the Turrish Case (421), which presents the simple case of the sale of the entire assets of a company, that no further discussion is needed as to that case.

The Hornby Case (422) also presents questions quite distinct from any heretofore decided by this Court in the mining cases.

In the first place, the court will observe that no contention is made that no profit can arise from the conversion and the sale in converted form of capital assets such as timber. The complaint shows that in the year 1914 the Cloquet Company, after charging into its manufacturing cost the fair market value as of March 1, 1913, of its own timber consumed, made a profit of 24% upon its capital stock, and that the respondent Hornby, having received his share of those profits by dividend, accounted for them as profits and income and paid his tax upon them without protest.

In the second place, the case of a manufacturing business (such as the Hornby Case) does not seem to us to present the question of depletion at all. When a manufacturer uses raw material he considers it and accounts for it, as a cost or expense of manufacture. If he uses more raw material or sells more goods in one year than he acquires, it does affect his net income, but not by way of depletion or depreciation. He has merely converted a capital asset, and to the extent that the cost or value is thus realized, he *has* no income, and needs no allowance for depreciation *as such* in order to determine his net income. It will be observed that the Cloquet Company did not take an allowance for depreciation for the value of raw material consumed, but charged it directly into manufacturing cost. This is the ordinary—the universal system of book-keeping for lumber companies. It is equivalent in method and results to the ordinary method of all manufacturers and merchants. The correctness of the

method is recognized in the Regulations of the Treasury Department under the Act of Sept. 8, 1916. The first paragraph of Regulations 33 (Revised) Art. 173, is as follows:

> "Corporations owning timber land and logging off the timber and manufacturing it into lumber, will, if the timber was acquired prior to March 1, 1913, be permitted to exclude from gross income either through a deduction from gross receipts *or through a charge into the cost of manufacturing the timber into lumber*, an amount equivalent to the fair market price or value of the standing timber as of March 1, 1913," etc.

But even if a lumber company by its operations were considered to have suffered a depreciation or depletion of its assets, and to be entitled to deduction therefor only by way of an allowance for depreciation, there is nothing in the mining cases referred to which affect the right to such an allowance. In the Stratton Case the right even of a mining company to such an allowance was assumed, and in the Von Baumbach Case, although it was refused, this was because of the *peculiar nature of the mining business and* the wording of the Act of 1909, and the court pointed out that the apparent unfairness of the Act of 1909 had been remedied in the Act of 1913 (under which the cases at bar arise). It was said:

> "It may be admitted that a fair argument arises from equitable considerations that, owing to the nature of mining property, an allowance in assessing taxes upon income should be made for the removal of the ore deposits from time to time. Congress recognized this fact in passing the Income Tax section of the Tariff Act of 1913, Section II, 38 Stat. 166, 167, when it permitted 'a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in

> the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made."

The cases of *Coltness Iron Co. v. Black* (1881), 6 App. Cas. 315, and *Kauri Timber Co. v. Commissioner of Taxes* (1903) App. Cas. 771, cited and much relied upon by the Government as sustaining its contention, are clearly not in point, and of little, if any, value in construing our law, being based upon the peculiar and vastly different characteristics, language, and provisions of the English tax laws.

Coltness Iron Co. v. Black arose under Chapter 6 of 5 and 6 Victoria, which imposed a tax, *not upon income,* but *upon the value of mining properties,* such value to be estimated at the full amount for one year, or the average amount for one year, *"of the profits received therefrom"* within a certain time limited in the act. Certain rules were prescribed for ascertaining the *"profits received therefrom"* and among these rules was one providing in part that:

> "In estimating the balance of profits and gains chargeable under schedule D, or for the purpose of assessing the duty thereon, no sum shall be set against or deducted from such profits or gains * * * on account of loss not connected with or arising out of such trade, manufacture, adventure or concern; *nor on account of any capital withdrawn therefrom;* nor for any sum employed or intended to be employed as capital in such trade, manufacture, adventure or concern."

The tax levied under Schedule D in the English law is really nothing more or less than a tax on property measured by its annual value.

The case of Kauri Timber Co. v. Comr., *supra*, arose under the land and income assessment act of 1908 (No. 95 of the Consolidated Statutes of New Zealand), ss. 71, 79 and 87, which provided for a tax upon income derived from business, employment or emolument. The act provided that:

> "In ascertaining the income derived from business, employment or emolument, no deduction shall be made in respect to any of the following items: * * * (c) *Investment of capital; expenditure of capital; loss of capital; capital withdrawn.*"

A mere statement of the statutory provisions show how wholly inapplicable these cases are to the provisions of the Income Tax Law of 1913. Some of the language in the Kauri Timber Co. case may be applicable to conditions in New Zealand, but not in this country.

C. *The Government's Theory of "Capital" and "Income."*

The respondents have been somewhat embarrassed by the fact that the Government's brief in these cases was received late in the afternoon of February 23, and then only an unpaged printer's proof, marked "subject to change." Consideration of time and distance made it imperative that the major part of this brief be prepared before that time. In that work of preparation the government's theories had to be assumed, and it is now found difficult to co-ordinate those assumptions with what now appears to be the petitioner's fundamental contention. An attempt will be made, however, in this portion of the brief, to analyze and comment upon the government's position.

Stripped of legal and academic verbiage, that position seems to be this:

1. Income is everything that comes in.

2. Net income is the same thing *less* only the deductions specifically provided for in the Income Tax Act.

3. These definitions, or concepts, are applicable to the Income Tax Law of 1913.

The court must remember that these cases involve the construction of an *Income Tax Law*, not an abstraction. When, therefore, counsel departs from all judicial definitions and decisions, (as he does quite frankly); from all previous legislative and judicial conceptions of both income and net income, and offers for the Court a conception which is new except to some economic writers, it is to be expected that what he offers will at least be logical, practical, and consistent with the express language of Congress.

(a) What is the source of this conception of income? There can be no doubt on this point. If the court will read Prof. Irving Fisher's work on "The Nature of Capital and Income" it will find a complete glossary to the nomenclature of the government's brief. The book is not one on income taxation; no attempt is made to define income for taxation purposes (as we shall show later); the entire work is simply an academic discussion of the relations between "capital" and "income" and the discussion is an abstraction raised to the highest degree. But any one reading the book will find that the government's counsel has, after all, adopted only the *nomenclature* of Prof. Fisher's discussion, and has attempted to twist that no-

menclature to his own purposes, without in the least adopting or carrying to their logical conclusion Prof. Fisher's ideas. It is impossible within reasonable limits to state those ideas fully, but here are some of them:

> "The flow of its (capitals) services is its income * * * any dis-service is a negative service * * * and flow of dis-service or negative service is called outgo."

Possibly we will not be accused of entire misconception of the author's distinction between capital and income, if we say that his conception of capital (with reference to property whose value is measurable in money) is that it is static wealth, while income is dynamic wealth, performing services for its owner. Professor Fisher would include at least all gross receipts from sales (and many other things) as the services of capital, and he would include all investments and all outgo as dis-services. The difference between the first and second would be "net income."

Applying these conceptions to actual facts:

X, Y, and Z each purchase property in 1913 for $100,000.00. X sells his in 1913 for $100,000.00. There is no profit, of course, but there is (under Prof. Fisher's conception) a *flow of services* (income) equivalent to $100,000.00; however the *dis-service* of his capital (outgo) is also $100,000.00 *so he had no net income* for 1913. Y holds his property until 1914 and then sells it for $100,000.00 and invests it in 1914 in other property. In his case there is no "service" in 1913 to balance the "dis-service", so he has a net outgo, but no net income; in 1914 the service (income) and dis-service (outgo) balances, so he has no net income. Z does not sell in 1913; he sells it

in 1914 for $100,000.00, but (unlike Y) does not reinvest until 1915. He has a net outgo of $100,000.00 in 1913, and a *net income* of $100,000.00 in 1914 (because he has a flow of services measured by $100,000.00, offset by no outgo.)

(See illustrations in Fisher, "The Nature and Service of Income," pp. 127-133-163.)

Does the government seriously contend that this is a logical or *practical* concept of income for taxation purposes? Of course not. We repeat that counsel has in adopting the mere nomenclature (and a part only of that) of what is in itself a logical (though abstract) concept of income, has not adopted and dares not adopt the concept as a whole, and failing to do so, robs it of all its logic. Professor Fisher would be the most surprised man on earth to find that his nomenclature as to "flow" of "services" has been bodily dragged away from a concept to which such nomenclature is alone apropos, and which is not that of the tax laws under consideration.

The fallacy of attempting to use Professor Fisher's concept of income with reference to a law taxing net income becomes more startling in view of the fact that the author says (pp. 138, 161) *that a corporation can have no net income whatever*; that the services of its capital (income) must always be equalled by the dis-services (outgo) and there never can be any net income.

To make sure, however, that he should not be understood to have been attempting to define income which could, or should be taxed, and that he was not in any way advocating the taxation of incomes based upon his concept, he added as a part of an appendix, a statement to that effect. It will be remembered that we have said that

under his conception of income, neither X, Y, nor Z, if they sold all of their property after the inception of the Income Tax Law, and re-invested it the same year, would have any net income. If, however, X sold his in 1914, and happened not to re-invest it until 1915, then the service done him by his capital under Professor Fisher's definition, was done in 1913, and the dis-service in 1914. It is this particular element which makes it impracticable, as Professor Fisher says, to adopt his conception of income for the purposes of taxation. He says (p. 400):

> "Theoretically, an income tax should tax every element of income, large or small, positive or negative. That is, all positive items should have a tax and all negative items a bounty. This system would be ideal in theory, but difficult to carry out in practice.
>
> No attempt is made in this book to contrive a practical system of taxation which would avoid all the difficulties which have been pointed out as belonging to systems now in use. It is undoubtedly true that it would be impracticable to assess taxes on each article on the basis of the actual items of income it yields; for most of such items are simply the positive sides of "interactions" and are offset as outgoes in the accounts of some other article of capital. *To carry out such a system in detail would require that we levy taxes on the proceeds of every sale and remit them on every investment.* It would be difficult to avoid injustice, evasion, and fraud if the attempt were made to assess taxes on such income and remit, as would be required logically, taxes on the corresponding outgo. The taxpayer would contrive to exaggerate his outgo and understate his income. Consequently, the system is not wholly unjust which exempts from taxation that part of income which stands for impairment of capital, and assess taxes on that part which swells capital, or savings."

(b) The argument of counsel that *gross receipts* are the gross amount of gains, profits and income, and that

these *gross receipts* less certain specified deductions are *taxable net income under the law of* 1913 seems almost grotesque in the light of a number of the provisions of the law, all of which seem aimed at keeping capital intact, and not including it in gross income.

1. In the first place, the tax is on *net income* (Par. A) and such net income includes *"gains, profits and* income derived from," etc. (Par. B). The government offers no satisfactory solution which explains this definition in any way other than we have explained it hereinabove on p. 24, to-wit: that only that income is included which is in the nature of gains and profits.

2. *Gains, profits and income* derived from sales, or dealings in property * * * *growing out of* the *ownership or use or interest* in real or personal property, are included in *net income* (Par. B).

3. The *income from* but not the value of property acquired by gift, devise, and descent, is included in net income.

4. *Payments made by the insured* on life insurance, endowment, or annuity contracts, *upon the return thereof* to the insured, are not included as income.

5. Losses actually sustained during the year incurred in trade or arising from fires, storms, or shipwreck, *and not compensated for by insurance or otherwise,* are deductible.

6. Debts due to the tax payer actually ascertained to be worthless and charged off within the year, are deductible.

7. An allowance for exhaustion, wear, and tear, (all of which are losses of capital), may be deducted.

(c) The government's argument that gross receipts are the basing point for net income, is in contravention to the construction placed upon the Act by the Treasury Department, and to the administration of the law during the entire term it has existed. Counsel's present conception of income, carried to its logical conclusion, necessarily means that a merchant or manufacturer can have no deduction from gross sales for the cost of replacing the goods sold or the material consumed, *because no such deduction* is permitted by the Act. A merchant's stock is his capital. As he converts it by sale, he must, counsel says, return the gross proceeds, less expenses, etc., as net income; there is nothing in the law which allows for a deduction of the *capital expenditure* necessary to replace his stock. But the Treasury Department has always treated gross income *not* as gross receipts, but as gross profits. See the following articles of the regulations governing the administration of the law of 1913:

Regulations 33, Art. 13
" " " 96
" " " 97
" " " 104 (Appendix p. vi.)
" " " 105 (Appendix p. vi.)
" " " 106 (Appendix p. vi.)
" " " 107 (Appendix p. vi.)

It is perfectly apparent that in every case the Treasury Department treated the "gross amount of income" or the income from which the "deductions" were to be made to determine *taxable* net income, not as gross receipts or

gross sales, but as gross profits. We need not allude again to the rule that courts in cases of doubt give more or less weight to the construction placed upon the act by the Department charged with its administration. In this case, however, attention should be called to the fact that ever since 1913 the administrative rules above referred to have been in force. We think it would not be too much to say that if what the Department of Justice now contends for is correct, not one individual or corporation in four has paid the tax which should have been imposed upon him.

(d) The Government's conception of income is not in accord with the ideas, practices and accounting methods of business. We understand that this is practically conceded in counsel's brief. If not conceded, it is perfectly obvious. If this new conception of "income" is correct, the profit and loss accounts of all mercantile, manufacturing or other business corporations are worse than useless in determining annual gains, profits and income. And it would be impossible to devise a practicable system of keeping books which would reflect "income" as defined by the government.

(e) Counsel cites no judicial authority whatever which accords with his theory of income. It will be noticed that all of the English cases cited by him in which it is considered that the sale of assets can give rise to income at all, all refer to the *profit* arising from a sale as income, not the gross proceeds.

(f) Counsel's theory contraverts the basic theory of an "Income Tax." The champions of that system of taxa-

tion base their argument on the principle that the income tax is based on "ability to pay." Very apparently relative "ability to pay" does not depend on gross receipts, nor even on gross income, nor on net income, unless capital in changed form is excluded from income. The Government by its present contention would foist upon the country a tax measured not by profit, not by increase in wealth, not by ability to pay, but largely with reference to the number of times a taxpayer changes the form of his capital. That this would result in the grossest inequality and injustice, needs no demonstration.

Excess profits tax rates (levied by the Act of Oct. 3, 1917) now run as high as 60%. Sur taxes on individual incomes now (by the same act) are as high as 65%. Is it possible that this court is going to find that Congress intended that part of gross receipts which simply represents *capital* in a changed form to be subject to such rates of taxation? The conduct of business would be impossible under such circumstances. Counsel says that when a company changes the form of capital the gross receipts are income. Concededly no deduction is permitted for replacement of this capital (except by way of allowances for depreciation and depletion, which are inapplicable to sales or complete conversions). Now suppose that under the present excess profits and income tax acts, the taxes of a company amount to 50% of its "income" (gross receipts less the limited deductions). The company, in all probability, has not enough *profits* to pay its taxes, and it would have no *fund* to pay them from *provided* it replaced its consumed assets, as every going concern must do.

(g) The Act of Sept. 8, 1916, re-enacting, with but slight changes, the income tax law of 1913, provides (Sec. 2, Subd. c):

> "(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived."

As we shall show later, this must be considered simply as declaratory of the real meaning of the Act of 1913. For the present, we wish to point out this: The Act of 1916 is otherwise almost identical with the Act of 1913 in every respect affecting the question of what is income from the conversion of property. Now if counsel is right in his concept of income, then, under the Act of 1916, in case of the sale or other disposition of property acquired after March 1, 1913, the *gross sale price* is income, but if the property was purchased before March 1, 1913, only the amount realized over its then value is "gain derived." Note particularly the language "for the purpose of ascertaining the *gain derived.*" Is not this the clearest possible assertion by Congress that "income" from *sales or other disposition* of property is *not* gross receipts—is not the Government's present concept of income—but only the *gain* derived from the sale or other disposition?

D. *The Government's Brief Generally.*

We wish to call attention to a few misconceptions in the government's brief.

1. We do not contend that the sale or other conversion of property cannot give rise to taxable income. What we

claim in the Hornby Case is the right to charge into manufacturing cost timber converted in a year subsequent to March 1, 1913, at its value on that date. The complaint shows that after this charge was made the Cloquet Company made a large profit in 1914. We admit that the Government is entitled under the Act of 1913 to have that charge kept constant from year to year, and that therefore necessarily the Government will be entitled to collect and will collect a tax on the increase in the value of the timber *after March* 1, 1913, as well as the purely manufacturing profit. In other words, the respondents never have claimed the right to charge timber into manufacturing cost at its value at the time of conversion, and thereby not account for the increase in value after March 1, 1913. In the Turrish Case the whole theory of the complaint is that by the sale of all the Payette Company's holding *no increase in value after March* 1, 1913, was realized by the sale. Counsel for the Government does not appear to be quite frank in saying that the reasons of the Courts below for their decisions in the Turrish Case, and in Doyle v. Mitchell Bros. do not appear. It seems to us perfectly clear that the controlling reasons for both decisions were that the property of a corporation or individual at the inception of a tax law, is capital at its then value, and does not become taxable income when thereafter converted. Neither decision can be twisted into a declaration that sales of property—even permanent assets, can never give rise to taxable income.

2. It is said that the "Commissioner of Internal Revenue assessed Turrish on the difference between what he paid for his stock and what he received on this distribu-

tion." It is true that the amount upon which the tax was assessed *happened* to be this difference, but the Commissioner did not know what Turrish paid for his stock, and the tax was not assessed on this theory. The tax was assessed because Turrish got a dividend, not because he made a profit. See T. D. 2163, supra, p. 16.

3. If there is any difference between "capital value" and "market value" it is unimportant in our cases. In both the *actual market value* of the property disposed of was alleged and admitted by demurrer.

4. Counsel for the Government seems inclined to argue that the Civil War Acts were more restrictive in their definition of income than the Act of 1913. The converse is the case. In none of them was *net* income the basis of taxation. All were, it is true, based upon "annual" "gains, profits or income" or "gains, profits and income for the year." It does not appear to us, however, that "net income" that is, "gains, profits and income * * * arising and accruing during the preceding calendar year" (as in the Act of 1913) can be said to be more inclusive than the much more general language of the Civil War Acts.

5. In the Government's brief it is stated at one place that the Payette Company, in the Turrish Case (421) was organized for the purpose of buying, selling and dealing in lands. As we have shown in the statement of facts, this purpose is negatived by the allegations of the complaint; unless indeed it can be said that because a corporation has the incidental power to sell that which it has the power to buy, it is therefore organized for the purpose of buying, selling, and dealing in property for profit.

V.

Dividend Question.

*Extraordinary distributions by a corporation, in the form of dividends or otherwise, made out by monies realized from a final disposition and conversion into money at the value on the effective date of the law, of assets of the corporation then owned by it as an integral part of its business, and then constituting part of its capital or surplus, are not, within the meaning of the law, "Gains, profits and income * * * derived from * * * dividends," and are not for that reason or any other, taxable income to the stockholder receiving the same.*

In discussing this question we shall assume that we are correct on the "Capital Assets Question." If we are, then if either Mr. Turrish or Mr. Hornby individually had owned the share in timber or other assets which gave their stock its value in 1913, and had sold that property, or if either had sold his stock in 1914, neither would have received any taxable income.

Does it make any difference that instead of selling their stock, the value of it was liquidated (wholly in Mr. Turrish's case and partially in Mr. Hornby's case) by means of liquidating distributions or dividends? The Internal Revenue Department says it does, and this ruling we have challenged in these cases.

It is said that these distributions were taxable *because they were dividends*, and that the law taxes all dividends declared and paid after it went into effect. But, in the first place, the law does not say that net income shall

include *dividends*, but only *"gains, profits and income derived from * * * dividends"* (Par. B). Now a corporation has no way of distributing anything to its stockholders except by pro rata distributions, called dividends. If a corporation is in final liquidation, and is distributing its original capital (at par value) to its stockholders, it does so by what are called dividends. If "dividends" are taxable simply because they are dividends, then such distributions would constitute taxable income, and Mr. Turrish should have been taxed upon the *whole* of the distribution made to him ($159,950) and not upon half, as was the case.

But even the government concedes that dividends distributing the original paid in capital of a corporation are not net income. The mere receipt of a dividend therefore does not necessarily mean the receipt of net income within the meaning of the law.

On the other hand, all would concede that ordinary current dividends do constitute income when received.

We have then this situation: All dividends are not income. Some clearly are and some clearly are not "gains, profits and income * * * derived from * * * dividends." To which class do the distributions in question belong?

The government says that these distributions were taxable because one has no title to the earnings of a corporation until a dividend is declared, and *therefore* it must be income when declared. This is a *non sequitur*. The reasoning is perfectly illogical and inconsistently applied. A stockholder has likewise no *title* to the *assets* of a corporation, even those constituting its original capital. When that property is distributed to the stockholder in

the form of a liquidating dividend, he gets something which he did not have before, but that fact does not make it income to him, otherwise all dividends including the final liquidating dividends by which the original capital is returned to the stockholder, would be income and taxable as such.

It is impossible to distinguish between the interest which a stockholder has in a capitalized surplus, and that which he has in the assets representing the original capital stock. In the case of the Payette Company, for instance, the property in which its original capital was invested, increased in value without increasing in quantity or changing its character until it was worth $3,000,000, or twice the capital stock of the company. The company actually had, therefore, a surplus of $1,500,000, but the entire value of its property, $3,000,000, was its capital, as distinguished from its capital stock. Mr. Turrish had precisely the same interest in the increase in the value which had accrued since the time of the first purchase, as he had in the value which was represented by the amount of capital stock. The attempt, therefore, to distinguish between dividends paid out of a capitalized surplus, the payment of which decreases the capital of the Company employed in its business, and at the same time the value of the stockholders' stock, on the sole ground that a stockholder has no title to a dividend until he gets it, falls of its own weight. Indeed the Internal Revenue Department has been led into hopeless confusion by the attempt to make any such distinction.

It will be observed that under the Treasury Department's theory of dividends, if the Cloquet Company (in 422) or the Payette Company (in 421) had in February,

1913, declared a stock dividend equal to their surplus, i. e., had *formally* capitalized their respective surpluses, then the distributions in question would not have been taxable, because a liquidation of *capital* and not of *surplus*.

(a) *The Government Contentions.*

It is not quite clear from the brief for the Government whether the question which we have called "the dividend question" has any separate status in the minds of the government counsel. So much is said with reference to and so much stress placed upon the government's distinction between capital and income, that it is not impossible that it is expected that all of the cases will stand or fall upon the correctness of that argument. In other words, we are not sure the Government (the Department of Justice) supports the Treasury Department in making these distinctions:

Assume that if Mr. Turrish had bought timber in 1903, and it had increased in value on March 1, 1913, to the value at which he converted it in 1914, *there would be no taxable income.*

Assume that if Mr. Turrish had sold his stock in 1914 for $159,950.00 (its value on March 1, 1913, and the exact amount he got on the distribution) *there would be no taxable income.*

Nevertheless, because his capital was in the form of stock, *and* because he did not sell it, but received a liquidating "dividend" and surrendered his stock, there *is* taxable income; and the taxable income would be the same whether he paid par for his stock, or the exact amount that he received in the distribution.

If these distinctions are now insisted upon by the government counsel, it is solely because of what is said in Part II of his brief "Group 1 (a), (b) and (c)." And the whole argument may be thus stated: that a corporation is an entirely distinct entity from its stockholders; that the stockholders have no property interest in its surplus until it is distributed in dividends, and that "gain, profit and income" necessarily "arises and accrues" to the stockholder (within the meaning of the Act) when he gets the *legal* title to part of the surplus and not before. To these propositions he cites:

Humphreys v. McKissock, 140 U. S. 304;

Gibbons v. Mahon, 136 U. S. 549;

and in another part of his brief are cited the following cases from Wisconsin:

Van Dyke v. Milwaukee, 159 Wis. 460;

Sallie F. Moon Co. v. Wisconsin Tax Commission, 163 N. W. 639;

Pfister v. Widule, 163 N. W. 641;

Nunnemacher v. Widule, 163 N. W. 644.

It is interesting to note that counsel cites no *income tax case* in his favor except those from Wisconsin. And with these he is not satisfied, because he cannot reconcile them with

Bundy v. Nygaard, 163 N. W. 307,

and because the later ones so clearly distinguish the Turrish case.

Van Dyke v. Milwaukee, *supra*,

was decided with only one dissenting judge (Judge Barnes, whose dissenting opinion will repay the reading,

as Judge Sanborn pointed out in his decision in the Turrish Case). The decision is not authority here, because of

The Facts. It was alleged in the complaint in the Van Dyke Case, that the plaintiff could not segregate the part of the dividend he received from current earnings and the part which represented surplus.

The Law. The Wisconsin law provides that the taxpayer must return, as part of net income, *dividends*. The Federal Act of 1913, says that net income includes the "gains, profits, and income" * * * "arising and accruing during the preceding calendar year" * * * "and derived from * * * dividends." The Wisconsin Court has itself pointed out this difference in the laws as being in itself a proper and sufficient reason for Judge Sanborn's refusal to follow Van Dyke v. Milwaukee in the pending cases. (163 N. W. 640, and again 163 N. W. 643.)

The Reasons Given. Among these is the reason given by the Government now in support of their position, i. e., that a stockholder has no property interest in a surplus until he receives a distribution. But this is a false premise, as we shall show from the decisions of this Court, and it applies to capital as distinguished from surplus, so that the logical result of the Wisconsin rule will be to tax final distributions liquidating original capital paid in. Another reason is the supposed difficulty of determining from what fund a dividend comes. Of this reason it may be said that it applies as well to distributions of original capital paid in as to surplus; that everyone knows that a corporation can always tell from what fund a

dividend is made; that Congress has recognized the practicability of it in the Acts of Sept. 8, 1916, and Oct. 3, 1917 (see below in this brief under heading "Legislative Construction"); and finally that the complaints in *these* cases demonstrate that no such argument is applicable here.

Finally, Van Dyke v. Milwaukee is in direct conflict with the Federal cases arising under the Civil War Acts.

Following the Van Dyke case came the decision of the same court in Bundy v. Nygaard, *supra*. Then came the other Wisconsin decisions cited above. When these were decided Judge Barnes (the dissenter in the Van Dyke case) was not on the bench, but three out of seven judges dissented, some of those who concurred in the Van Dyke case being convinced that that decision was wrong. And in both the Sallie Moon case and the Pfister case, the Court reconciles the Van Dyke case and the later decisions with the decision in the Turrish Case in a way which seemed to be satisfactory to it, even if it is not to the Government.

In Humphrey v. McKissock, *supra*,
it appeared that several railroad companies combined to construct an elevator, each contributing an equal sum toward its cost, and each receiving corresponding amounts of the stock in the corporation which was organized to construct and take title to the elevator. It was held that none of the railroad companies had any interest in the property itself (the elevator) which it could mortgage.

This is simply one of the cases which hold in one form or another, that the legal title to a corporation's property is in the corporation, and not in the stockholders. We do

not deny the correctness of this general rule, but as we have already pointed out, it seems to us that it has no significance in determining the precise question which is involved in this case. That a corporation owns its own assets and that a stockholder has no *legal title* to them, is of course a correct and settled rule. It is nevertheless true that Courts look through this more or less arbitrary rule to find the verities of any particular case. The fiction of corporate personality is not only convenient and useful, but it is necessary for the transaction of modern business, and yet the conception of the legal entity must not be permitted to obscure the real facts and the real situation, and Courts do not permit themselves to forget that a corporation is simply a collection of stockholders.

Mr. Morawetz in his book on Private Corporations, Section 237, says:

> "The relation between the corporation and its several members may for practical purposes be treated as that of trustee and *cestui que trust*. In contemplation of law the property and rights of an incorporated association belong to the corporation as an entity and not to the shareholders. *The latter, however, are the real parties in interest.*"

In United States v. Milwaukee, etc., Transit Co., 142 Fed. 247, Judge Sanborn said:

> "A corporation, from one point of view, may be considered an entity without regard to its shareholders; yet the fact remains self-evident that it is not in reality a person or thing distinct from its consistent parts. The word "corporation" is but a collective name for the members who compose the association."

As we shall hereafter show, Congress did not in fact treat the corporation and the individual as wholly dis-

tinct entities for the purposes of the Act of 1913. Instead it treated the corporate income as one with reference to both the corporation and the individual, collecting *part* of the tax from the corporation, and *part* from the stockholder.

Counsel says:

> "Evidently it would be regarded by everyone as a flagrant misuse of terms to say that a stockholder had received a certain income during a certain year because the corporation had during that year added to its surplus without any further action. Clearly, therefore, on general principles, it is improper to say that the income in question accrued to the *plaintiff* prior to 1913."

Here the Government is quite mistaken, as the following authority in this court will show:

Collector v. Hubbard, 12 Wall. 1.

Under the Income Tax Act of 1864, a stockholder in a certain class of companies was required to return as income all gains and profits, made by the companies to which he should be *"entitled,"* whether the same were *"divided or otherwise."* One Hubbard owned stock in a corporation, which had certain gains and profits for the year 1864. This corporation invested those profits in part in real estate, machinery and raw material, proper for carrying on its business, and in part used them for the payment of its debts incurred in previous years, and the same so remained invested in 1865, when Hubbard made his return. He included dividends which had been paid by this company, but not the profits of the company which had been invested, and claims specifically that as the profits were invested by the company in real estate, ma-

chinery and raw materials and used to pay its debts, *he was not entitled to it or any part of it* and that they *could not constitute income to him in that year.* The Supreme Court said:

> "Decided cases are referred to (Minot v. Paine, 99 Mass. 106; Goodwin v. Hardy, 57 Me. 145), in which it is held that a stockholder has no title for certain purposes to the earnings, net or otherwise, of a railroad, prior to the dividend being declared, and it cannot be doubted that these decisions are correct as applied to the respective subject matters involved in the controversies. Grant all that, still it is true that an owner of a share of stock in a corporation holds the share with all its incidents. * * * *Profits are incident to the share to which the owner at once becomes entitled,* providing he remains a member of the corporation until a dividend is made. Regarded as incident to the shares, *undivided profits are property of the shareholder,* and as such are the proper subject of sale, gift or devise. Undivided profits invested in real estate, machinery, or raw material, for the purpose of being manufactured *are investments in which the stockholders are interested,* and when such profits are actually appropriated to the payment of the debts of the corporation, *they serve to increase the market value of the shares,* whether held by the original subscribers or by assignees. * * * Annual gains, and profits, whether divided or not, *are property* and therefore are taxable." (Italics ours.)

Here we have, in a decision of the Supreme Court of the United States *and in an income tax case,* the converse of the contention of the government. What the Supreme Court said (paraphrased) was that when *in a past year* the Cloquet Lumber Company, instead of returning to its stockholders the profits which it then made, *reinvested* them in *corporate assets proper for use in its business,* then the stockholders are properly said to have had gains

and profits *during that year*. The stockholders immediately *acquired a property* in the investment, which was that year gains and profits to them. Now if this is so, then, of course, the mere conversion of these property rights into money or another form of property in 1914, cannot also be gains or profits *for that year*.

It seems to us that this one decision disposes of every authority which the government cites and of the only reason upon which the Government bases or can base its distinction between a distribution made from liquidation of capital assets and the sale of stock itself.

There is nothing in Gibbons v. Mahon, *supra*, (not a tax case) inconsistent with our position. Indeed this court there said:

> "Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, *it follows that the interest therein, represented by each share, is capital*, and not income, *of that share*, as between the tenant for life and the remainderman, legal or equitable, thereof." (Italics ours.)

(b) *Dividends from surplus established before inception of law are not Income when declared thereafter.*

Fortunately, however, there are cases precisely in point on the question as to whether dividends declared out of a capitalized surplus, established prior to the inception of an income tax law, are "gains, profits and income derived from dividends" when paid out in the form of dividends after the law goes into force:

Merchants Insurance Co. v. McCartney, 17 Fed. Cas. 46 (No. 9443), 1 Lowell 447.

Bailey v. Railroad Co., 106 U. S. 109.

Chicago B. & Q. Ry. Co. v. Page, 1 Biss. 461, 5 Fed. Cas. 600, No. 2668.

Reynolds v. Williams, 20 Fed. Cas. 625 (No. 11734), 2 Blatch. 555.

In Merchants Insurance Company v. McCartney, 17 Fed. Cas. 46, (No. 9443) 1 Lowell 447, it appears that the plaintiff owned stock in a bank, and as such stockholder received $115,000 as its share of an extra dividend declared by the bank January 3, 1865. Of the dividend declared by the bank, about three-tenths consisted of profits laid aside *before the passage of the first (Civil War) Internal Revenue Law, and of profits of sales of real estate bought before that time;* on the remaining seven-tenths, the bank paid a tax to the Government, but denied their liability for the three-tenths and it had never been exacted of them. The defendant, who was the Internal Revenue Collector for the District in which the plaintiff resided, collected of the plaintiff, against their protest, a tax of five per cent upon the whole sum received by them. This tax was laid under the provisions of the Act of June 30, 1864, and especially Sections 116-121 (13 Statutes 281). The law imposed a tax upon the annual *gains, profits, and income* of every person "whether derived from any kind of property, rents, interest, dividends, etc., or from any source whatever."

The plaintiffs contended that no part of the dividend paid them by the bank was liable to assessment in their hands, *because as to the three-tenths it was not income,* and as to the seven-tenths that it had already paid the tax.

Judge Lowell in his decision said:

> "As to the three-tenths, it seems to me to have been a *division of capital,* a return to the plaintiffs in money of *a part of the property which was already in their ownership as capital stock when the first Tax Act was passed.* If the Suffolk Bank had been wholly wound up and had returned to its stockholders the exact values of their shares in money, having made no profits *since the passage of the original Act,* this sum of money could not be taxed as income, gains or profits; and so of a part * * * it is not a dividend out of gains and profits nor out of the surplus funds, *because the surplus funds that are taxable are those, which are or have been made out of profits since the passage of the Act.* * * * *If this money was capital in the hands of the bank, it was still capital when it reached the stockholders."* (Italics ours.)

The Government in these cases seeks to explain this case on the ground that it was doubtful whether the tax was really on the corporation paying the dividend, and not on the stockholder. It is true that there was a long standing difference of opinion in this Court upon the question whether the tax imposed under Sections 116 and 121-2 upon dividends was upon the shareholder or upon the corporation. Railroad Co. v. Jackson, 7 Wall. 262; Barnes v. The Railroad, 17 Wall. 292; United States v. B. & O. R. R., 17 Wall. 322; Stockdale v. Ins. Co., 20 Wall. 329; Bailey v. N. Y. C. & H. R. R. Co., 22 Wall. 604; Railroad Co. v. Collector, 100 U. S. 595; Bailey v. N. Y. C. & H. R. R. Co., 106 U. S. 109.

But this difference of opinion had not arisen in 1870, when Merchants Ins. Co. v. McCartney was decided. The law in this court at that time certainly was that it was a tax on the shareholder (Railroad Co. v. Jackson, *supra*). No tax could have been assessed against the Merchants

Insurance Company if that were not the law, and Judge Lowell expressly found that the tax was one on the shareholder, and not on the corporation. He said:

> "The tax is assessed on the bank for convenience, but is intended to be, in effect, a tax on the shareholders; and if the latter be not assessable for the income tax it cannot be levied on the corporation. Railroad Co. v. Jackson, 7 Wall. (74 U. S.) 262."

The case of Bailey v. Railroad Co., *supra*, is also directly in point. The New York Central Railway Company, being prohibited by law from paying dividends in excess of 10%, had invested its earnings over and above that amount, from the years 1853 to 1868, in improvements. In 1868, the railroad company made to its stockholders, pro-rata, a distribution in certificates aggregating the sum which had been so invested out of its prior earnings. Upon the first decision of this case, in 22 Wall. 604, the court held that this dividend was a scrip dividend within the meaning of the law of 1862, which imposed a tax of 5% upon the amount of all dividends or profits declared by a railroad company. When the case again came to the Supreme Court (106 U. S. 109), it was urged by the Government:

> "that, upon the express terms of this section, the certificates in question being a declaration of a dividend as part of the earnings, profits, income, or gains of the company, are taxable upon the amount thereof without deduction; that the policy as well as the language of the act fixes the charge upon the declaration itself when made effectual as between the company and its stockholders, and, for the purposes of taxation, concludes both as to the amount subject to the tax; and that the rule is reasonable as furnishing an obvious standard and the only safe criterion for the assessment of the tax to prevent fraudulent evasions.

> And consequently that when such a dividend has once been declared, and ascertained to come within the description of the law as a subject of taxation, all the rest follows, and the amount declared is necessarily established as the amount to be taxed."

But this Court held that *the portion of the dividend which represented the earnings of the years prior to the inception of the law,* and which had been invested by the railroad company prior to that time, *was not taxable income within the meaning of the law.*

Counsel for the government in these cases says that this case is not particularly significant "because of the doubt whether the tax was levied on the stockholder or on the corporation" (referring evidently to the prevailing difference in opinion in this court above referred to). But the case *is* of direct and particular significance because in the course of its opinion the court said:

> "There has been a difference of opinion upon the point whether the tax imposed by this section is upon the corporation on account of its net profits, or upon the income of the stockholder or bondholder; *although in the present case it is immaterial which of these alternatives is adopted.*" (Italics ours.)

In the case of C. B. & Q. R. R. v. Page, 5 Fed. Cas. 600 No. 2668, which arose under the Act of July 1, 1862, (12 Stat. 469), the railroad company had from time to time, prior to 1862, make advances to another railroad, taking mortgages therefor. After the passage of the act the mortgages were foreclosed and stock certificates were issued to stockholders representing their pro rata interest in the property acquired. It was held that the stock thus issued did not constitute "dividends due and payable during the year 1862," it being capital when the law went into effect.

Reynolds v. Williams, 20 Fed. Cas. 625 No. 11734, arose under the income tax law of 1864 (14 Stat. 478), providing for a tax upon "the gains, profits and income" derived from any source whatever. It was held that under that law a fund in the hands of a trustee for the use of stockholders which had been turned over to the trustee in 1867 upon the consolidation of one railroad with another, the said fund being accumulated earnings of the railroad company up to and prior to 1863, could not be taxed, the fund accruing to the stockholders by the transfer to the trustee not representing gains, profits or income for the year 1867.

(c) *When dividends are income as between life tenant and remainderman.*

The question as to whether distributions by corporations out of accumulated surplus are income when received, or a mere return of capital, arises often in the matter of the construction and enforcement of trusts for the payment of income from stocks to certain persons during life, with remainder over.

There has been some conflict in the decisions in this country on this question, but the great weight of authority in America is in favor of the correctness of the following rule, stated in Thompson on Corporations, 2nd Ed. Section 5414:

> *"The courts now inquire into the actual nature and source of dividends for the purpose of determining their character;* and as between the life tenant and remainderman, if they are found to represent earnings that accrued prior to the creation of the trust, they belong to the corpus of the trust; or if they

represent the natural growth and increase in the value of the corporate plant and business, whether that growth and increase took place before or after the trust was created, they are to such extent capital. *The court in making the inquiry concerns itself with the substance of the transaction, and not the form in which the corporation has seen fit to clothe it.*"

Whatever conflict there has been, we think that it may be said that practically all of the authorities hold that when a corporation sells or otherwise finally disposes of all or a part of the assets used in its business, so that to that extent it has depleted its future earning power, and distributes the money or property received to its stockholders, such monies are not income when paid (provided the assets liquidated were owned by the company at the beginning of the life estate), but are a mere return of capital—the corpus of the trust fund, and belong to the remainder man.

Mercer v. Buchanan, 132 Fed. 501.
Case of Osborne, 209 N. Y. 450, 103 N. E. 723.
Thayer v. Burr, 201 N. Y. 155, 94 N. E. 604.
Goodwin v. McGaughey, 108 Minn. 248.
Soehnlein v. Soehnlein, 146 Wis. 330.
Earp's Appeal, 23 Pa. St. 368.
Vinton's Appeal, 99 Pa. St. 434.
Boardman v. Boardman, 78 Conn. 651; 62 Atl. 339.
Kalbach v. Clark, 133 Ia. 215; 110 N. W. 599.
Gilkey v. Paine, 80 Me. 319; 14 Atl. 205.
Thomas v. Gregg, 78 Md. 545; 28 Atl. 565.
Day v. Faulks, 79 N. J. Equity, 66; 81 Atl. 354.
Cobb v. Fant, 36 S. C. 1, 14 S. E. 959.
Ex parte Humbird, 80 Atl. 209.
Cook on Corporations, 7th Ed., Vol. 2, page 1632.

There are very full notes collecting cases on this subject in 12 L. R. A. N. S., page 768 (and particularly subdivisions d and e of paragraph VII), in 35 L. R. A. N. S. 563, and in 50 L. R. A. N. S. 510. These notes are continuations of each other, and review the decisions on the subject down to date.

In the case of Osborne, *supra*, it is said in the course of the opinion (p. 730):

> "It is conceded that the capital of a corporation cannot be divided among the life beneficiaries. It is not alone the *capital of the corporation that should be preserved*, but *the capital of the trust fund*, whether invested by the trustees in stocks of corporations at a premium or acquired from the testator or maker of the trust. *The surplus of the corporation, existing at the formation of the trust or when the stock is purchased, represents a part of the capital of the estate as fully as does the capital of the corporation.*"

In Mercer v. Buchanan, 132 Fed. 501, it appeared that a trust had been created to pay "the income" of the trust fund to the donor during her life, then to her daughter during her life, remainder to the latter's children. A portion of the trust fund consisted of stock in the A. Company. The donor died. Almost immediately thereafter the A. Company sold a large part (not all) of its capital assets, but retained assets of a net value exceeding the par value of the capital stock. The Company had acquired the large surplus of assets thus disposed of by investing earnings of previous years (during the donor's lifetime) and also by reason of the gradual rise in value of its assets (exactly the Cloquet Company's case). The Company distributed the money received by it for this *sale* of assets to its stockholders during the daughter's

lifetime. The question arose, was this income of the period of the daughter's lifetime so that she was entitled to it. The Court held not, saying in an opinion which is illuminating throughout:

> "These dividends were pro tanto a liquidation and distribution of the backbone and corpus of the Apollo Company. * * * Would any stockholder who received these unusual and extraordinary dividends regard them as profit or income which he could spend and consider that his capital or principal still remained intact? Would he not treat them as capital and regard them as the income-producing corpus which must be by him reinvested to in turn produce the dividends which the Apollo Company, by the sale of its plants, was to that extent depriving itself of the power of earning and declaring? * * * It is not shown here when this increment or profit was made. Whenever it was earned or whenever it accrued, certain it is that it was before Mrs. Mercer's life tenancy began. Not having been earned during the tenancy, it cannot, when substance is considered, be deemed income. * * * As such, we think, it is to be regarded, as was the increment on the bonds of trust in Gray v. Darlington, 15 Wall. 65. * * * So here we cannot regard the proceeds of the sale of this plant as income. It was the bone, sinew, and corpus of the company."

(d) *Law itself negatives intention to tax distributions in question*

We still assume that we have reached the right conclusion upon the "Capital Assets Question."

If there were no decisions supporting our present contention, and if it were to be conceded that dividends such as the defendants in error in these cases received, may for certain purposes and in some circumstances be considered to be income when received, nevertheless the law

itself is so drawn that we think that it bears upon its face the strongest possible negation of any intent on the part of Congress to tax such a dividend. It must always be remembered in construing the law of 1913, that it is not a law taxing "income" or "net income," and leaving these terms to be entirely defined by the Department or the courts. If, within the definition and rules of computation contained in the statute itself, something received by an individual is not included in net income, then it is not taxable, although it is something which in the abstract sense and without reference to the language of the Act, might be regarded as income. In attempting to construe the Act of 1913, it is peculiarly important that the language of Congress and the form of the Act be studied and analyzed with care, because we start with the knowledge that the term "net income" is used in a limited sense. We have already pointed out that net income is not defined as including dividends, but as "gains, profits, and income" (arising or accruing in the preceding calendar year) *"derived from * * * dividends."*

A study of the law, without the extraneous assistance afforded by definitions and previous decisions, reveals that under the plain and specific terms of the Act, *no normal tax is or can be in any manner at any time, or from any source, levied, assessed or collected on such distributions as are involved in these cases.* It further follows from the language of the Act, that there being no normal tax, there is no income tax upon such a subject matter. *No additional tax can be levied or assessed upon a subject matter which is not reached by the normal tax.*

Obviously the individual stockholder himself never pays a normal tax on *any* dividends received from a corpora-

tion which is itself taxable on its net income. This necessarily results from the fact that *whatever dividends* are to be included as "gain, profit and income derived from * * * dividends" (Paragraph B) the same dividends are to be deducted (in computing the normal tax) as "the amount received as dividends upon the stock, or from the net earnings of any corporation * * * *which is taxable upon its net income as hereinafter* (Paragraph G) *provided*" (n. b. *not* dividends upon which the normal tax has been paid).

The Department recognizes that whatever is to be included under the former language is to be excluded (in computing the normal tax) under the latter, because by the form of return adopted (Form 1040, Revised) the individual is instructed to deduct on line 4 the same amount entered on line 27. This deduction, however, does not of course depend on the regulations or forms described by the Department; it is a right given by law. In fact, when an individual has an income derived solely from dividends from corporations *taxable on their net income,* he does not go through the process of inclusion and deduction at all—provided that he does not receive more than $20,000. One of the provisos of Paragraph D is as follows:

> "Provided, further, that persons liable for the normal income tax only, on their own account or in behalf of another, shall not be required to make return of the income derived from dividends on the capital stock or from the net earnings of corporations, joint stock companies or associations, and insurance companies *taxable upon their net income as hereinafter provided.*"

Therefore the normal tax is *never* collected directly *from the individual* on "gains, profits and income derived

from * * * dividends," *whatever that term may mean.*

But this does not mean that the normal tax is not collected at all on "income derived from * * * dividends." Congress did not intend to create or define a subject of taxation and then not tax it. And it is when we find the character of receipts that are actually reached by the normal tax, that we find the true subject of taxation included in the term "income derived from * * * dividends."

Why is the individual not required to pay the normal tax on certain kinds of income? Solely because the tax has been paid for him through another source. Under paragraph G, the normal income tax is imposed on corporations. This tax is upon "the entire net income arising and accruing from all sources for the preceding calendar year." When the corporation pays this tax, it pays the normal tax on the subject of taxation described as "income derived from dividends." The very fact that dividends—ordinary current dividends—are paid to the stockholder by a corporation "which is *taxable* upon *its* net income" is given by the law, and by the return in the form prescribed, exactly the same effect as, and is in fact, payment of the normal tax at the source.

But if we are correct in our contentions upon the "capital assets question," a corporation never pays for itself or for its stockholders the normal tax on its surplus created out of earnings or increases of value occurring before the law became effective. In the case of the Payette Company, the $1,500,000 which it received in 1914 over and above what it paid for its property, was not earnings or income to the Payette Company, taxable under the income

tax law, and as a matter of fact, it has never been called upon to pay, and has not paid, any tax upon that sum. And in the case of the Cloquet Company, while the Cloquet Company paid in the year 1914 an income tax upon its own earnings for that year, which it distributed to its stockholders, and which we concede were earnings to the stockholders, it did not pay, and was not taxable upon, the sums received as a result of a mere change in the form of its capital assets. So of the two funds received by Mr. Hornby in the year 1914, one, constituting his ordinary dividend which he voluntarily included in his first return, had already borne the normal income tax, but the other had not, and never could under the law, be assessed for the normal tax. We repeat that Congress did not intend to define a subject of taxation and then not tax it, and therefore when we find what particular dividends are actually reached by the law with the normal tax (which is the income tax), we find the true line of demarcation between those dividends which are and which are not "gain, profit and income derived from * * * dividends."

But it may be said that while it is plain that Congress did not intend or provide that there should be collected from any source, or in any manner, or at any time, the normal tax on such dividends as we are discussing, that nevertheless, an additional tax may be levied and collected. In other words, it is apparently contended that Congress intended to impose an additional tax in cases where there was no normal tax; that the subject matter to which additional taxes were to attach was to be broader and more inclusive than the subject matter upon which it was intended to levy a normal tax. If any contention ever answered itself, this certainly does. The additional tax is

just what the natural meaning of the word implies. The words of Congress are:

> "In addition *to the income tax* provided under this section (herein referred to as the *normal income tax*), there shall be levied, assessed and collected * * * an *additional* income tax (*herein referred to as the additional tax.*)" (Paragraph A.)

It is impossible to state the matter more clearly than Congress itself has done. If there is no normal tax, then there is no income tax, and there can be nothing additional to that which does not exist. In fact, another clause in Subdivision 2 of paragraph A, reads as follows:

> "All the provisions of this section (Sect. II—the entire Income Tax Law), relating to individuals who are to be chargeable with the normal income tax, so far as they are applicable and are not inconsistent with this subdivision of Paragraph A, shall apply to the levy, assessment, and collection of the additional tax imposed under this section."

It is apparent when one reads the law that Congress had a certain definite conception and plan with regard to gains, profits and income earned, or arising out of the use of the property owned, by corporations at the date of the tax law. If all of the physical property in the country were owned by corporations, then the total value of all of that property would be the measure of the value of the real capital wealth of the country. Out of that wealth or capital there could really grow but one "fruit," which would be the real income of the country. It is possible that within constitutional limitations, Congress *might* have conceived of the property of corporations as one wealth, and the stock in the corporations held by individuals as another and entirely separate wealth and source of income, and might have considered the income of the

corporation as one separate and distinct subject matter for taxation, and all dividends received by stockholders as another separate and distinct subject matter for taxation. But no such situation confronts us, for the simple reason that Congress had no idea of taxing what was really one income in two different aspects. It treated the fruit or income arising out of the ownership and use of property belonging to corporations as the income at once of the corporations and of the individual stockholders. There was only one subject of tax in mind, and that was the gains, profits and income arising out of the profits of business of the corporations. This income was to bear both the normal, or income tax, and the additional tax, the former to be paid by the corporation, and the additional tax to be paid by the individual, as the same fund reached the individual. The additional tax is simply an incident of the income tax, and is aimed to reach those individuals who receive more of the kind of receipts which are subject to the income tax than their less fortunate fellows.

The term "gains, profits and income derived from * * * dividends" therefore must necessarily mean regular and current dividends, because generally speaking it is only upon the fund from which such dividends are paid that the normal tax is collected or attempted to be collected. We are not contending that dividends paid in the future by corporations, out of surplus created from earnings after the inception of the tax law, will not be taxable as they come to individuals. Whether a corporation divides such earnings each year among its stockholders or not, it pays the normal tax on them, so that whenever these earnings are distributed to the stockholders, then there will be a distribution to them out of a fund which

has already borne the normal tax. Our present contention is confined to distributions made by corporations out of a capitalized surplus existing prior to March 1st, 1913.

(*e*) *Department's rule results in inequality and injustice.*

It is apparent under the specific language of the law, and the rules and regulations of the Department, if a stockholder receives only $20,000 of dividends of the kind which we are here discussing, in the year 1914, and that was his only income, such income would bear no tax whatever. If the contention of the government is to be adopted, that if a man receives *more* than $20,000 of this character of dividends (there being no other income), then a tax—the additional tax—is to be levied upon the excess, the necessary result is to create a complete exemption of such "income" up to the amount of $20,000. It seems to us that this results, if not in an absurdity, in an injustice and inequality which is shocking to the moral sense, and no court should presume for a moment that Congress intended any such result.

Nor is this the only injustice and inequality which results from the Department's Rule. It is obvious that the conservative business man who has done business under the corporate form (and so far that form is still recognized in legal and judicial circles as legitimate) and who has not watered the stock of his corporation; who has been content not to increase the stock whenever he wished to leave his profits in the business; who has not been a "spender", but a conservator and builder, is placed at a disadvantage which is not justified by any form or

degree of reason or justice. A premium is placed upon and given to the man who represents everything which is the antithesis of sound and conservative business, good morals, and public benefit.

(*f*) *Legislative Construction of the Act of 1913 with Respect to "Dividends."*

1. Congress in enacting the law of 1913, in almost exactly the same language (with respect to dividends) as contained in the Civil War Acts and particularly in the Act of June 30, 1864, (13 Stat. 381), which was involved in Merchants Insurance Co. v. McCartney, *supra*, must be held to have done so in the light of the decisions of the Federal Courts under the Civil War Acts, holding that "gains, profits or income * * * whether derived from property, rents, interest, *dividends*," etc., "or from any source whatever" (we have quoted the language of the Act of 1864), did not include dividends from *capital or surplus* existing at the effective date of the law. In other words, when in the Act of 1913 "net income" was defined in almost identically the same language, Congress adopted with the language the construction which had theretofore been placed upon it by the Federal Courts.

2. After the passage of the Act of 1913, it was more than a year before there was any regulation or decision of the Treasury Department with reference to the taxability or non-taxability of dividends. After the ruling by the Department, which is contested in these cases, disputes arose immediately between taxpayers and the Government over the very question here involved. A number of suits, in addition to these, were instituted in the Fed-

eral Courts, challenging the correctness of the Government's ruling, including

Southern Pacific Co. v. Lowe, 238 Fed. 847;

Gulf Oil Corporation v. Lewellyn, 242 Fed. 709.

This was the situation in September, 1916. Title I of the Act of Sept. 8, 1916, (39 Stat. 771) is practically a re-enactment of the Act of Oct. 3, 1913, with but very few changes. The substantial changes are in the rates of the normal and additional taxes, in provisions for returns by fiduciaries, in the matter of depletion charges, particularly for mines, in the matter of deductions for losses on occasional investments, etc. But as a whole, the Act is a continuation of the Income Tax Law of 1913. The plan, form, arrangement and language of the two acts are almost identical. It is true that the Act of 1916 was not *in form* an amendment to the Act of 1913, but for all practical purposes it was intended to accomplish and did accomplish the same result. The statement of what net income shall include is found in the first part of Par. B of the Act of 1913, and Sec. 2 (a) of the Act of 1916. The two provisions are printed in parallel columns in the Appendix (p. vi), and it will be seen that in substance they are identical, *except* that in 1916 Congress added a proviso construing the term "dividends," which term was used in exactly the same way and in exactly the same connection in the Act of 1916, as in the Act of 1913.

We assert that the proviso "that the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint stock company, association or insurance company, *out of its earnings or profits accrued since March first, nineteen*

hundred and thirteen," etc., is under the circumstances which we have detailed, a legislative construction of the same term in the Act of 1913.

The rule of construction to be applied is thus stated in United States v. Freeman, 3 How. 556-564.

> "The correct rule of interpretation is, that if divers statutes relate to the same thing, they ought all to be taken into consideration in construing any one of them, and it is an established rule of law, that all acts *in pari materia* are to be taken together, as if they were one law. Doug., 30; 2 T. R. 387, 586; 4 Man. & Sel. 210. If a thing contained in a subsequent statute, be within the reason of a former statute, it shall be taken to be within the meaning of that statute; Ld. Rayn. 1028; and if it can be gathered from a subsequent statute *in pari materia* what meaning the legislature attached to the words of a former statute, they will amount to a legislative declaration of its meaning, and will govern the construction of the first statute. *Morris v. Mellin,* 6 Barn. & C. 454; 7 Id. 99."

The rule has been applied by this court in cases almost precisely similar to those at bar.

In Bailey v. Clark, 21 Wall. 284, it appeared that Sect. 110 of the Revenue Act as amended July 13, 1866, provided:

> "That there shall be levied, collected, and paid a tax of one twenty-fourth of one per centum each month * * * upon the capital of any bank, association, company, or corporation, and on the capital employed by any person in the business of banking beyond the average amount invested in United States bonds."

During the years 1869 and 1870, Clark and others were bankers within the meaning of this statute, and made returns as required by law of the amount of their fixed capital employed in banking, and of the amount of

monies deposited with them by their customers. The Commissioner of Internal Revenue insisted that all monies borrowed by them from time to time, and temporarily in the ordinary course of their business, formed a part of their capital employed in the business of banking, and were subject to the tax imposed upon capital. Clark et al. paid under protest a tax assessed upon this theory, and brought an action to recover. In the year 1872 Congress passed an Act entitled "An Act to Reduce Duties on Imports, and to Reduce Internal Taxes and for Other Purposes" (17 Stats. at Large, 230). Section 37 of this Act was as follows:

> "That the taxes imposed by section one hundred and ten of the act entitled "An act to provide internal revenue to support the government, to pay interest on the public debt, and for other purposes," approved June thirtieth, eighteen hundred and sixty-four, as amended by section nine of the act of July thirteenth, eighteen hundred and sixty-six, to reduce internal taxation and to amend the act aforesaid and acts amendatory thereof, upon the deposits, capital, and circulation of banks, or persons, associations, companies, or corporations engaged in the business of banking, shall hereafter be paid semi-annually, on the first day of January and the first day of July; but the same shall be calculated at the rate per month as prescribed by said section, so that the tax for six months shall not be less than the aggregate would be if the said taxes were collected monthly, as prescribed by said section. *And the words 'capital employed' in said section, shall not include money borrowed or received from day to day, in the usual course of business, from any person not a partner of or interested in the said bank, association, or firm.*"

Section 46 of the same Act is as follows:

> "That all acts and parts of acts inconsistent with the provisions of this act are hereby repealed: *Pro-*

vided, that all the provisions of said act, shall be in force for levying and collecting all taxes properly assessed, or liable to be assessed, or accruing under the provisions of former acts, the right to which *has* already accrued, or which may hereafter accrue, under said acts, and for maintaining, continuing, and enforcing liens, fines, penalties, and forfeitures incurred under and by virtue thereof. And this act shall not be construed to affect any act done, right accrued, or penalty incurred under former acts, but every such right is hereby saved, and all suits and prosecutions for acts already done in violation of any former act or acts of Congress relating to the subjects embraced in this act may be commenced or proceeded with in like manner as if this act had not been passed."

With regard to the effect of this Act of 1872, this Court said:

> *"After controversies had arisen* as to the interpretation to be given to the statute, upon the question at issue in this case, between bankers and the government, Congress passed the act of 1872, defining the meaning of the terms 'capital employed', in the one hundred and tenth section, and enacted that they 'shall not include money borrowed or received from day to day in the usual course of business from any person not a partner of, or interested in, the said bank, association, or firm.' (17 Stat. 256.) *This enactment was evidently intended to remove any doubt previously existing as to the meaning of the statute and declare its true construction and meaning. Had it been intended to apply only to cases subsequently arising it would undoubtedly have so provided in terms."*

In the cases at bar, *controversies had arisen* respecting the meaning of the Act of 1913, with respect to dividends, and Congress passed the Act of 1916 not changing the provisions as to dividends, but defining the meaning thereof. The definition was not more or less prospective than in

the amendatory act in Bailey v. Clark, *supra*, and in all respects that case seems to be on all fours with these.

In *Wetmore v. Markoe*, 196 U. S. 68, the question was whether under the Bankruptcy Act of 1898 as originally passed, arrears of alimony awarded to a wife against her husband for the support of herself and their minor children, under a final decree of absolute divorce, was a provable debt barred by a discharge from bankruptcy. After the discharge of the bankrupt in this case, Congress amended the bankruptcy law by the Act of February 5th, 1903, and by this amendment expressly excepted from the operation of a discharge in bankruptcy a decree for alimony due or to become due or for the maintenance and support of the wife and minor children. Before the decision in this case, and before the passage of the statute, this Court had decided (Audubon v. Shufelt) that where the decree for alimony was subject to the continuing control of the court rendering the decree, and to change and modification, that the judgment was not barred by a discharge. The decree in this case was not so subject to the control of the court, but was an absolute decree for the payment of money. With regard to the effect of the Act of 1903 it was said:

> "It is urged that the amendment of the law made by the act of February 5, 1903, excepting from the operation of a discharge in bankruptcy a decree for alimony due or to become due, or for the maintenance and support of the wife and minor children, is a legislative recognition of the fact that, prior to the passage of the amendment, judgments for alimony would be discharged. In *Dunbar v. Dunbar*, 190 U. S. 340, cited *supra*, it was said that this amendment, while it did not apply to prior cases, may be referred to for the purpose of showing the legislative trend in the direc-

tion of not discharging an obligation of the bankrupt for the support and maintenance of wife and children. The amendment may also have been passed with a view to settling the law upon this subject and to put at rest the controversies which had arisen from the conflicting decisions of the courts, both State and Federal, upon this question. Indeed, in view of the construction of the act in this court in *Audubon v. Shufeldt, supra*, it may be said to be merely declaratory of the true meaning and sense of the statute. *United States v. Freeman*, 3 How. 556; *Bailey v. Clark*, 21 Wall. 284, 288; *Cope v. Cope*, 137 U. S. 682, 688."

The Act of Sept. 8, 1916, was passed (only a few days) after the decisions of the Court of Appeals in the cases at bar, and does nothing more than declare the true meaning of the Act of 1913, just as it was declared by the Court of Appeals in these cases.

Johnson v. Southern Pacific Company, 196 U. S. 1, was an action for damages brought under the Railway Appliances Act of Congress, being the Act of March 2, 1893, 27 Stat. 531. The accident took place August 5, 1900. Section 2 of this Act was as follows:

> "That on and after the first day of January, eighteen hundred and ninety-eight, it shall be unlawful for any such common carrier to haul or permit to be hauled or used on its line any car used in moving interstate traffic not equipped with couplers coupling automatically by impact, and which can be uncoupled without the necessity of men going between the ends of the cars."

The question in the case was whether a locomotive was a car within the meaning of this section.

On March 2, 1903, Congress passed an Act (32 Stat. 943) amending in some particulars the Act of 1893, and

providing among other things that the provisions and requirements of the former Act

> "*shall* be held to apply to common carriers by railroads in the Territories and the District of Columbia, and shall apply in all cases, whether or not the couplers brought together are of the same kind, make, or type;" and "shall be held to apply to all trains, locomotives, tenders, cars, and similar vehicles used on any railroad engaged in interstate commerce."

This act was to take effect September first, nineteen hundred and three, and nothing in it was to be held or construed to relieve any common carrier 'from any of the provisions, powers, duties, liabilities, or requirements' of the act of 1893, all of which should apply except as specifically amended.

With respect to the effect of this Act of 1903 upon the construction of the former act, the Court said:

> "As we have no doubt of the meaning of the prior law, the subsequent legislation cannot be regarded as intended to operate to destroy it. *Indeed, the latter act is affirmative, and declaratory, and, in effect, only construed and applied the former act. Bailey v. Clark,* 21 Wall. 284; *United States v. Freeman,* 3 How. 556; *Cope v. Cope,* 137 U. S. 682; *Wetmore v. Markoe, post,* p. 68. *This legislative recognition of the scope of the prior law* fortifies and does not weaken the conclusion at which we have arrived."

Other cases in this court applying the rule to situations similar to that in the cases at bar are

Tiger v. Western Investment Co., 221 U. S. 286.

Cope v. Cope, 137 U. S. 682.

Bowling v. U. S. 233 U. S. 528.

N. Y. & Norfolk R. R. Co. v. Peninsula Exchange, 240 U. S. 34.

3. In the Act of Oct. 3, 1917, Congress imposed rates of income tax, both normal and additional, very substantially in excess of previous rates. In doing so, however, an amendment was made to the income tax law which is illuminative as showing the general plan or purpose of that law with reference to the earnings of corporations, and that Congress has at all times had in mind just what we have contended, i. e., that the individual stockholder is the real taxpayer with reference to corporate earnings, and that his liability to taxation depends (just as does the liability of the corporation for the normal tax) upon the *period* in which the earning accrues to the corporation. It is true that the surtax is not *collected* from the individual until he receives his dividend, but nevertheless it is treated as income accruing to him at the same time that it accrues to the corporation. The provision is as follows (Sub. (b) Sec. 31, Act of Sept. 8, 1916, as amended by Act of Oct. 3, 1917, Public No. 50—65th Congress):

> "Any distribution made to the shareholders or members of a corporation, joint stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, *and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint stock company, association, or insurance company,* but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first nineteen hundred and thirteen, has been made."

Conclusion.

The judgments in Lynch v. Turrish (421) and Lynch v. Hornby (422) should be affirmed.

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APPENDIX.

T. D. 2090:

"*Profit* is the difference between the selling price and the cost where the selling price is more than the cost.

Cost of property purchased prior to the incidence of the special excise tax (Jan. 1, 1909), or the incidence of the income tax (March 1, 1913) will be the actual price paid for the property, including the expense incident to the procurement of the property in the first instance and its sale thereafter, together with carrying charges of interest actually paid, insurance, and taxes actually paid prior to the incidence (special assessments, if any, 'actually paid' as 'local benefits' in connection with real estate); provided that where, up to the incidence of the tax, the expense of carrying property has exceeded the income from it, the difference between the expense of carrying and the income from the property shall be added to the purchase price, and the sum thus ascertained shall be the cost of the property; and provided further, that in the case of property purchased prior to the incidence of the tax and sale thereof subsequent to the incidence of the tax, there shall be excluded from consideration in ascertaining cost of any items of income, expense, interest and taxes previously taken into account in preparing a return of annual net income.

The cost of property acquired subsequent to the incidence of the tax will be the actual price paid for it, together with the expense incident to the procurement of

the property in the first instance, and its sale thereafter, and the cost of improvement or betterment, if any.

The entire profits realized by individuals or corporations from the sale of real estate will be taxable except where the property in connection with which the profit is obtained was acquired prior to March 1, 1913, in the case of individuals, or prior to January 1, 1909, in the case of corporations; and then and in such event the profit will be prorated over the whole time the property was held, and that part of the whole profit apportioned to the taxable period will be reported in annual returns of income. In prorating, fractional parts of years will not be considered."

Reg. 33, Art. 108:

"For the purpose of determining the income resulting from the sale of capital assets and the amount to be accounted for as income under this act, there shall be included any and all profit resulting from such sale and which may be apportioned to the period during which the corporation tax law (Sec. 38, Act of August 5, 1909) was in force and effect, which was not returned as income during that period."

Reg. 33, Art. 109:

"In ascertaining net income derived from the sale of capital assets, if such assets were acquired subsequent to January 1, 1909, the difference between the selling price and the buying price shall constitute an item to be added to or subtracted from gross income according to whether the selling price was greater or less than the buying price. If the capital assets were acquired prior to January 1,

1909, the amount of profit or loss representing the difference between the selling and buying price is to be prorated to determine the proportion of the gain or loss arising subsequent to January 1, 1909, and the proportionate part belonging to the years subsequent to January 1, 1909, shall be added to or deducted from the gross income for the year in which the sale was made."

Reg. 33, Art. 110 (as amended by T. D. 2077):

"For the purpose of determining the amount of profit or loss arising from the sale of capital assets acquired prior to January 1, 1909, which shall be taken into account by corporations in making their returns of annual net income, the gain or loss represented by the difference between the purchase price and the selling price shall be prorated according to the number of years the assets were held prior to their sale, and the amount thus apportioned, or apportionable, to the years subsequent to January 1, 1909, shall be included in or deducted from the gross income of the year in which the assets were sold, accordingly as they were sold for more or less than their original cost. To any gain thus apportioned and to be included in income there should be added any amount, or amounts, which had been charged against and deducted from gross income, during the years since the inception of the special excise tax law, on account of depreciation and which had not been paid out in making good the depreciation—that is, any amount charged off subsequent to January 1, 1909, on account of the depreciation of the assets sold and not used to make good such depreciation shall be added to the gain apportioned to these years, and will be included in the income of the year in which the property

was sold. Likewise, for the purpose of deduction from gross income of the year in which the assets were sold, loss resulting from any such sale, apportionable to the years subsequent to January 1, 1909, will be reduced by the amount of the unused portion of the depreciation charged off with respect to such assets since January 1, 1909."

Reg. 33, Art. 111:

"In cases wherein there is an annual adjustment of book values of securities, real estate and like assets, and the increases and decreases in values, thus indicated, are taken up on the books and reflected in the profit and loss account, such readjusted values will be taken into account in making the return of annual net income and no pro-rating will be required. *If such an adjustment had been made annually prior to March* 1, 1913, *the book value of the assets at that date will be taken as the basis for determining gain or loss resulting from subsequent sale, maturity, or adjustment.* The adjustment referred to will comprehend assets which have increased in value as well as those which have decreased."

Reg. 33, Art. 139:

"Corporations owning tracts of timber land and removing therefrom and selling, or otherwise disposing of the timber will be permitted to deduct from their gross income on account of depreciation or depletion, an amount representing the original cost of such timber, plus any carrying charges that may have been capitalized or not deducted from income. The purpose of the depreciation or depletion deduction is to secure to the corporation,

when the timber has been exhausted, an aggregate amount which, plus the salvage value of the land, will equal the capital actually invested in such timber and land."

Reg. 33, Art. 140:

"When an amount sufficient to return this capital has been secured through annual depreciation deductions no further deduction on this account shall be allowed. For the purpose of increasing the deduction on this account, no arbitrary increase in value shall be made, unless such increase in value shall be returned as income for the year in which the increase in value was taken up on the books."

TREASURY DECISION 1571:

Sale of capital assets.—In ascertaining income derived from the sale of capital assets, if the assets were acquired subsequent to January 1, 1909, the difference between the selling price and the buying price shall constitute an item of gross income to be added to or subtracted from gross income according to whether the selling price was greater or less than the buying price. *If the capital assets were acquired prior to January 1, 1909, the amount of increment or depreciation representing the difference between the selling and buying price is to be adjusted so as to fairly determine the proportion of the loss or gain arising subsequent to January 1, 1909, and which proportion of the loss or gain arising subsequent to January shall be deducted from or added to the gross income for the year in which the sale was made.*

Comparison of Definitions of "Net Income" in Acts of 1913 and 1916.

Act of 1913.

B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits and income derived from

salaries, wages or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property,

also from interest, rent, dividends securities, or the transaction of any lawful business carried on for gain or profit,

or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent:

Provided, That the proceeds of life insurance policies paid upon the death of the person insured or payments made by or credited to the insured, on life insurance, endowment, or annuity contracts, upon the return thereof to the insured at the maturity of the term mentioned in the contract, or upon surrender of contract, shall not be included as income.

Act of 1916.

Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits and income derived from

salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property,

also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit,

or gains or profits and income derived from any source whatever: PROVIDED, THAT THE TERM "DIVIDENDS" AS USED IN THIS TITLE SHALL BE HELD TO MEAN ANY DISTRIBUTION MADE OR ORDERED TO BE MADE BY A CORPORATION, JOINT STOCK COMPANY, ASSOCIATION, OR INSURANCE COMPANY OUT OF ITS EARNINGS OR PROFITS ACCRUED SINCE MARCH FIRST, NINETEEN HUNDRED AND THIRTEEN, AND PAYABLE TO ITS SHAREHOLDERS, WHETHER IN CASH OR IN STOCK OF THE CORPORATION, JOINT STOCK COMPANY, ASSOCIATION, OR INSURANCE COMPANY, WHICH STOCK DIVIDEND SHALL BE CONSIDERED INCOME, TO THE AMOUNT OF ITS CASH VALUE.

Note: The portion of the Act of 1913 which is in black above appears in Section 4 of the Act of 1916.

Regulations 33:

Art. 104. Gross income of manufacturing companies shall consist of the total sales of manufactured goods during the year covered by the return, increased or decreased by the gain or loss as shown by the inventories of finished and unfinished products, raw material, etc., at the beginning and end of the year. To this amount should be added the income, gains, or profits from all other sources as shown by the books of account.

Art. 105. Gross income of mercantile companies shall include the total merchandise sales during the year, increased or decreased by the gain or loss as shown by the inventories of merchandise at the beginning and end of the year for which the return is made; to this amount should be added the income, gains or profits derived from all other sources as shown by the books of account.

Art. 106. Gross income of miscellaneous corporations consists of the total revenue derived from the operation and management of the business and property of the corporation making the return, together with all amounts of income, including the income, gains, or profits from all other sources as shown by the books of account.

Art. 107. It will be noted from these definitions that the gross income embraces not only the operating revenues, but also income, gains, or profits from all other sources, such as rentals, royalties, interest, and dividends from stock owned in other corporations, and appreciation in values of assets, if taken up on the books of account as gain; also profits made from the sale of assets, investments, etc.